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Serial No.

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on Banking, Finance and Urban Affairs

HOUSING AND URBAN-RURAL RECOVERY ACT OF 1982

HEARINGS

BEFORE THE

SUBCOMMITTEE ON

HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON

BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 4

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HOUSING AND URBAN-RURAL RECOVERY ACT OF 1982

WEDNESDAY, MARCH 31, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez (chairman of the subcommittee) presiding.

Present: Representatives Gonzalez, St Germain, LaFalce, Lundine, Vento, Garcia, Lowry, Schumer, William J. Coyne, Hoyer, Stanton, Wylie, McKinney, Thomas B. Evans, Jr., Bethune, Carman, and Bereuter.

Also present: Representative Minish.

Chairman GONZALEZ. The subcommittee will please come to order.

The subcommittee will continue its consideration of the pending legislative matters, and I have always believed that the hearings, particularly of this nature, should be accompanied by some presence that will reflect later after they are printed of the environment or backdrop against which we are proceeding along with the comprehensive hearings.

I ask unanimous consent that I may be permitted to place into the record at this point an article appearing in the business section of the New York Times yesterday, Tuesday, March 30, entitled "Housing Aid Offered by Reagan." Because this gives us a very, very good outline of what it is we, the legislative branch, must confront.

And an accompanying article, also appearing on Saturday, March 27 in the AFL-CIO News entitled "Housing Measure Pressed To Lift Sagging Economy."

[The articles follow:]

[From the New York Times, Mar. 30, 1982]

HOUSING AID OFFERED BY REAGAN

(By Howell Raines)

PROPOSAL EASES RULES, BUT HE BARS A "BAILOUT"

WASHINGTON.—President Reagan today proposed a five-step plan to aid the housing industry by increasing the flow of pension funds into the credit markets and by easing Government regulations on home mortgages.

But, in a speech to the National Association of Realtors here, Mr. Reagan refused to commit himself to lowering the $91.5 billion deficit his 1983 budget would entail.

The realtors and other business associations have repeatedly said that a lower deficit is needed to bring down the high interest rates that have put the housing industry in near-depression.

Sales of new single-family houses tumbled 11.8 percent in February, to the second-lowest monthly rate in at least two decades, the departments of Commerce and Housing and Urban Development reported. [Page D18.]

Mr. Reagan, while asserting that "housing is one of our highest social priorities," denounced plans to help the industry with "multibillion-dollar bailout schemes."

WON'T ENDORSE AID BILL

This apparently means Mr. Reagan will not endorse legislation to spur home construction by providing $1 billion in each of the next five years to subsidize mortgages for middle-income families. "You recognize, as I do, that budget-busting bailouts will only aggravate the interest rate problem—the underlying problem in the housing industry," Mr. Reagan said.

The President speaking in the same hotel where he was shot on March 30 of last year, also offered a strongly worded defense of his economic program, saying that any attempt to blame him for the current recession would sink compromise negotiations on the budget in "the quagmire of partisan debate."

Larry Speakes, the deputy White House press secretary, said that Mr. Reagan offered no comment on the scheduling that brought him to the Washington Hilton on the eve of the first anniversary of the attempt on his life.

Mr. Speakes also said that the White House was still observing its policy of not commenting on budget talks, between Reagan aides and Congressional leaders, despite demands today that the President become more actively involved in settling the budget stalemate.

Senator Bob Dole, the Republican chairman of the Finance Committee, adopted a tone of urgency in addressing the realtors before Mr. Reagan's arrival. "I really believe we're right on the threshold of a breakthrough, if the Congress and the President, working together, will sit down together and hammer out a budget," Senator Dole said. But, he added, "If we don't get it done in the next 30 days, we aren't going to get it done."

Sending a similar message in more partisan words, Senator Robert C. Byrd, the Democratic leader, said, "The President is going to have to move his feet out of cement and be willing to give, also." He specifically attacked Mr. Reagan's insistence that his plans to increase defense spending and reduce personal income taxes must not be altered in any compromise budget.

BUDGET DEMANDS REAFFIRMED

But Mr. Reagan, in his speech, reaffirmed those demands. He argued that resistance to his cuts in nondefense spending, rather than tax reductions, was the reason for the growth of the deficit.

"I have no quarrel with those who cry out every evening on the network news against the size of our projected deficits; I abhor them, too," the President said. "What I don't understand is how many of those same people can then retreat from the spotlight to vote in some Congressional committee to spend even more."

The President's five-part proposal to help the housing industry does not require Congessional approval, and some of its key elements, such as the use of pension funds to finance mortgages, have been announced earlier.

These are the five elements of the plan:

An easing of Government regulations on mortgage revenue bonds, which are issued by state and local governments, to provide mortgage funds for 50,000 more home buyers.

Further action under the previously announced plan to relax regulations under the Employment Retirement Income Security Act of 1974 to increase the money from labor union pension funds available for home mortgages.

Revision of Federal Housing Administration rules to allow more first time home buyers to qualify for mortgages on condominiums and to allow relatives to assist young people with down payments.

Relaxation of Government regulations limiting real estate firms' participation in related businesses such as providing title insurance.

Reduction of the processing time on F.H.A. loans.

Bill Ellingsworth, spokesman for the National Association of Realtors, said the group greeted Mr. Reagan's proposal today as an indication of concern, even though

his suggestions would not bring sweeping changes. "It's certainly not the answer, but it's a positive first step," the spokesman said.

[From the AFL-CIO News, Mar. 27, 1982]

Housing Measure Pressed To Lift Sagging Economy

A labor-supported legislative package designed to overcome a critical shortage of affordable housing can also help pull the nation out of recession, the AFL-CIO testified.

The federation endorsed key ingredients of a comprehensive housing bill introduced by Rep. Henry B. Gonzalez (D-Tex.), whose subcommittee has jurisdiction over most housing-related legislation.

It also supported the intent of a housing-related banking measure sponsored by Rep. Fernand J. St Germain (D-R.I.) who is chairman of the full Banking, Finance & Urban Affairs Committee.

Henry B. Schechter, who testified as director of the AFL-CIO Office of Housing & Monetary Policy, also urged renewal of the Credit Control Act, which otherwise will expire at the end of June. The law gives the President authority to channel available credit into productive uses and thus ease pressure on interest rates.

The Gonzalez bill includes additional authority for public housing construction and other existing programs which the Reagan Administration wants to scrap.

It would also activate a dormant program of federal subsidies for home purchases by families with incomes up to 130 percent of the national average, holding their payments to the equivalent of a 9.5 percent interest rate.

Schechter said the AFL-CIO especially welcomes a companion provision for subsidized rental unit construction targeted to areas of greatest need. But he urged that more than the 20 percent share provided in the bill be earmarked for families with incomes not higher than 80 percent of the local median. The percentage of rental housing in the overall package should also be increased, Schechter said.

The bill also includes emergency mortgage assistance, so that home owners who lose their jobs won't lose their homes if they can't meet mortgage payments. The recipients would be required to repay the funds advanced by the government to avoid foreclosure.

Schechter proposed tightening of some sections of the St Germain bill, to assure that savings institutions helped by federal loan guarantees to stave off collapse do in fact earmark half of new deposits for mortgages at reasonable interest rates. He said the institutions should be allowed to use up to 25 percent of net new deposits to finance rental housing.

All of these approaches, he testified, are among the "much-needed" steps that should be taken "to deal with the home building and home financing crisis which threatens to atrophy our housing supply and to lead to widespread financial instability, greater unemployment and prolongation of the economic recession."

Chairman Gonzalez. It is our great privilege to have the very talented and very successful young Congressman who has quite a backlog of experience as a staff assistant in the Senate before he became a Member of of the House. We welcome Congressman Norman Dicks, and thank him for taking this time to appear this morning.

STATEMENT OF HON. NORMAN D. DICKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Mr. Dicks. Mr. Chairman, I am deeply honored to be here today to present testimony before this very important subcommittee. Thank you for allowing me this opportunity to appear before you to discuss the slump in housing production and sales as it relates to my State of Washington and the Nation.

We are facing a crisis in the housing industry, and must act soon to provide a stimulus to this key link in the economy if we wish to prevent greater unemployment and a deeper recession.

Housing production is at its lowest point in 40 years. Yet it has been housing which has led the Nation out of recession in the past. Given the state of the industry at present, however, I doubt it will be able to serve that function without a stimulus.

In my State of Washington, unemployment in the forest products and timber industries now tops 30 percent, according to the Washington State Department of Commerce and Economic Development. Nationally, unemployment in these industries is nearing 20 percent. In construction, it is at least 18 percent.

The repercussions of a slump in housing make themselves felt not only in the lumber industry, but in the appliance, insulation, roofing, contracting, and plumbing industries. A decline in housing affects the small businessman and the large corporation. Its impact is felt throughout the economy.

But just as a decline in housing construction and sales has a widespread impact, a recovery in these industries could trigger improvement and growth in a broad spectrum of businesses. That is why I feel it is so important to give a push to housing now—to bottom out the recession, and get the Nation back on an even economic keel.

In 1981, less than 1.1 million housing starts were recorded. That is a 45 percent decline from the years 1977–78, when 2 million units were started. The National Association of Home Builders estimates an annual need for 2 million starts. The current housing shortfall exceeds 1.8 million units, and is expected to worsen.

High interest rates are largely to blame for the slump in housing. I was privileged to attend the field hearings this subcommittee sponsored in Seattle last summer, and heard from many builders at that time about the effect of tight money on their businesses. Rates have not declined dramatically since that time. As a result, many of the businesses we heard from that day are now bankrupt or barely scraping by.

Nationally, 686 construction companies failed in the first quarter of 1981. The previous cyclical peak was in the second quarter of 1975, when some 660 companies failed. During the peak construction period last year, 8 percent fewer construction workers were employed than in the summer of 1979. And the average workweek for those employees has declined from 38 hours in 1979 to 36 hours in 1981.

The impact on Washington State has been severe. Unemployment in my State now tops 13 percent. In many of the lumber counties, it exceeds 30 percent. Fifty percent of the real estate licensees are now inactive. Real estate sales in 1981 were off 25 to 35 percent in most areas as compared to 1980. Out of 270 sawmills in Washington State, 100 are closed or working curtailed shifts.

In 1981, the total value of new building contracts declined 10 percent from the previous year. Remember—1980 was also a recession year. Over the past 2 years, the total value has fallen nearly 30 percent. Permits for housing starts in Washigton State fell 24 percent from the 1980 level, and more than 50 percent from 1979.

Housing construction has been particularly depressed by high interest rates. Though half of the Nation's families could afford to buy a modest home in 1963; today less than 15 percent could afford that same home. And the difference is felt in the cost of money.

The market has adjusted to an extent through the development of new financing mechanisms.

In the Seattle area, for example, the Washington State realtors tell me that over 70 percent of all sales of single-family homes involve some form of seller financing. But we can only expect creative financing to take us so far. The Congress has to provide a stimulus to get the industry back on its feet. And I think many of us here today agree that such a program would be well worth the original outlays we would have to make to enact it.

The impact of a strong housing industry would be felt in increased employment and increased revenues at every level of government. These factors are the keys to our economic recovery—jobs and revenues. Even the administration's own economic advisers have admitted that there can be no sustained economic recovery without a recovery in the housing sector.

Mr. Chairman, I know you have introduced legislation to reauthorize the Nation's housing programs. I salute you for dealing with the need to stimulate homeownership for middle-income Americans as well as continuing the traditional programs for low-income families.

I have some suggestions for changes in the program you have introduced which I hope the subcommittee will consider. I have sponsored a bill, along with Congressman Swift, H.R. 5943, which builds on your basic premise but, by limiting the subsidy amount and duration, doubles the number of families who could be helped immediately.

I have also included language to make help available for families who wish to buy an existing, rather than a new, house. These are the basic differences. I hope the subcommittee will consider the many different options available during its review of a housing support program. But most of all, Mr. Chairman, I hope the subcommittee will act quickly to provide some help to the struggling industry. I pledge my assistance in this fight, and look forward to working with all of you to restore the economy through a housing stimulus package.

And finally, Mr. Chairman, a housing bill could serve as a key countercyclical device to stimulate the economy. In the context of a new budget, a housing stimulus bill could help to bottom out the recession and start the economy on the road to recovery. If you want to reduce the deficit, put the American people back to work. Every time unemployment is reduced 1 percent, we gain $20 billion in revenue and save $5 billion on benefits to the unemployed.

In the State of Washington, such a bill is desperately needed.

I would also like to add just as a footnote that as a member of the House Appropriations Committee, I am deeply concerned about the recommendations in the budget. I know this committee is, too, for substantial reductions in the authority of GNMA have been proposed. I think that reducing the level of authority for GNMA would be another devastating mistake made by this administration in the area of housing, particularly when it has little or no budgetary consequences.

So I hope we can work together in making certain that the Appropriations Committee does not approve the proposed 1982 rescis-

sions and opposes Draconian cuts in that authority in fiscal year 1983.

I appreciate the chance to testify here today.

[The text of H.R. 5943 follows:]

I

97TH CONGRESS
2D SESSION

H. R. 5943

To stimulate the production and sale of housing.

IN THE HOUSE OF REPRESENTATIVES

MARCH 24, 1982

Mr. DICKS (for himself and Mr. SWIFT) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To stimulate the production and sale of housing.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 235(g)(1) of the National Housing Act is amended—

(1) by striking out the first sentence and inserting in lieu thereof the following: "Notwithstanding any other provision of this section except subsection (i), the Secretary shall, to the extent authorized in appropriations Acts, make and enter into contracts to make periodic assistance payments on behalf of homeowners to

mortgagees or other lenders holding mortgages, loans, or advances of credit which meet the requirements of this subsection.";

(2) by striking out "September 30, 1982, or at such earlier date" in the last sentence and all that follows in such sentence through "no longer present," and inserting in lieu thereof "September 30, 1983,"; and

(3) by adding the following new sentence at the end thereof: "In addition to the contracts authorized in subsection (h)(1), the Secretary shall, to the extent approved in appropriation Acts, enter into contracts under this subsection; the aggregate amount paid per annum pursuant to such contracts shall not exceed $600,000,000, and the aggregate amount which may be obligated over the duration of such contracts may not exceed $3,000,000,000.".

(b) Section 235(q)(4) of such Act is amended—

(1) by striking out "25 per centum" and all that follows in subparagraph (A) and inserting in lieu thereof "30 per centum of the mortgagor's income; or"; and

(2) by striking out "at the rate of at least 9½ per centum per annum" in subparagraph (B) and inserting in lieu thereof "at a rate four percentage points below

the rate applicable to mortgages insured under such section 203(b)".

(c) Section 235(q)(5) of such Act is amended—

(1) by striking out "25 per centum" and all that follows in subparagraph (A) and inserting in lieu thereof "30 per centum of the manufactured homeowner's income; or"; and

(2) by striking out "determined by the Secretary", and all that follows in subparagraph (B) and inserting in lieu thereof "which is four percentage points below the rate applicable to loans or advances under such section 2."

(d) Section 235(q)(10) of such Act is amended—

(1) by inserting the following before the semicolon at the end of subparagraph (A): ", or in the case of an individual unit in a condominium or cooperative project, be a first lien or first mortgage described in section 203(n)(2)(A) or 234(b)";

(2) by inserting ", except as provided in paragraph (18)," after "which" the first time it appears in subparagraph (C);

(3) by striking out "82" in subparagraph (D) and inserting in lieu thereof "100"; and

(4) by inserting the following before the semicolon at the end of subparagraph (D): "or in the case of an

individual unit in a condominium project, which does not exceed 100 per centum of the applicable maximum principal obligation of a mortgage which may be insured in the area pursuant to section 234(c)".

(e) Section 235(q)(13) of such Act is amended to read as follows:

"(13) The Secretary shall allocate the amount available to carry out this subsection among the States on the basis of a formula so that—

"(A) one-third of such amount is allocated on the basis of the ratio of the population of each State to the population of all States;

"(B) one-third of such amount is allocated on the basis of the ratio of the decline of one- to four-family housing starts, measured from 1978 to 1981, of each State to such decline for all States; and

"(C) one-third of such amount is allocated on the basis of the ratio of each State's unemployment rate for the most recent month prior to the allocation to the unemployment rate for all States for such month."

(f) Section 235(q)(14) of such Act is amended by adding the following new sentence at the end thereof: "All funds received from recaptures under this subsection shall be utilized in accordance with paragraph (16).".

(g) Section 235(q) of such Act is amended by adding the following new paragraphs at the end thereof:

"(16)(A) There is hereby created a fund to be used in accordance with this paragraph. There shall be deposited into such fund all amounts recaptured pursuant to paragraph (14).

"(B) Such fund shall be utilized, to the extent approved in appropriation Acts, for the purpose of making payments pursuant to contracts described in paragraph (17)(B).

"(C) Money in the fund not needed for current operations shall be invested in direct obligations of the United States or obligations guaranteed by the United States.

"(17)(A) Except as provided in subparagraph (B), payments on behalf of any mortgagor under this subsection may not exceed 5 years.

"(B) In the case of any mortgagor who, as determined by the Secretary, is unable to assume full payments required by the mortgage after 5 years of receiving assistance under this subsection, the Secretary shall enter into a contract to provide continued assistance to the mortgagor under this subsection by utilizing the fund described in paragraph (16)(A).

"(18) Of the total amount of assistance available under this subsection, the Secretary shall make 30 per centum available with respect to mortgages secured by existing one- to four-family dwellings.

"(19) The Secretary shall make allocations and begin to issue commitments pursuant to this subsection not later than 30 days after the enactment of legislation appropriating funds to carry out this subsection."

Chairman GONZALEZ. Thank you very much, Congressman. We want to thank you for your role on the Appropriations Committee and what you have done in the past.

I think also the record should show that the Congressman has been extremely productive and helpful as a member of the Democratic Housing Task Force. And his suggestions certainly are very, very seriously considered.

And it just remains for me to point out, Congressman, that we appreciated your particular suggestions and we are aware of your bill. The only thing is that what we try to come up with after much consideration and discussion with the Budget Committee, above all, represents pretty much the basic suggestions you are making. We thought we would come up with just about as near bottom line as we could get and still satisfy the budget restrictions.

But given the nature of the President's message reported in this New York Times article I have offered for the record, our fight ultimately will have to come around on your level on the Appropriations Committee. But your help is invaluable and we are deeply grateful, and your bill certainly has been and will continue to be considered.

Mr. DICKS. Well, Mr. Chairman, I have been involved with that process for 13 years, partly as a Senate staffer as you mentioned. I am more worried about getting a bill out. I will trust this committee's expertise and judgment about the details.

There is a hemorrhage going on out there in the economy. The only way we are going to stop that hemorrhage is to do something to stop this recession from going further downhill.

And in the context of an adjusted budget that takes care of those outyear deficits, which we have got to do, it seems to me totally appropriate to have a housing bill emanating from this committee to put a floor under this recession.

I see my good friend, Mr. St Germain, he has some very important responsibilities in this area as well as it relates to the savings and loan industry. Because, I will tell you, we cannot risk a financial panic in this country, either. I think that could happen if we do not have an effort here in housing and in the savings and loan industry to restore some stability and some confidence.

What I am sensing—and I think our State is a little ahead of the national trend because our unemployment rate is higher—we are sinking out there. We are sinking. We are still going downhill. This recession has not bottomed out. I heard Mr. Greenspan this morning on national television saying that there are no signs of any economic recovery and there would not be until the budget is adjusted. I am very worried about the situation that we find ourselves in.

And I frankly believe that this housing legislation is desperately needed right now to help restore economic confidence in this country.

So I appreciate this co

Chairman GONZALEZ.

words a

Treasury

chief off

Chinese

cookie says you will get great wealth in a few months. But it does not tell you the particulars.

How many months? Or the amount?

Mr. DICKS. I am afraid when you open this Chinese fortune cookie, that there would not be anything inside, there is not any message.

Chairman GONZALEZ. Just the bare cookie.

Mr. Stanton?

Mr. STANTON. Well, I hope the cookie does not crumble. I do appreciate your testimony, and I apologize for being late. You certainly were right. We do have major problems and it is up to this committee to address many of them.

I appreciate that you are not only concerned because of the constituents you have in the Far West, but as a national legislator.

Mr. DICKS. I think this program can help solve a national problem. I think that something here, modest as it is, and with the recapture provisions and trying to recognize the impact on the budget and outlays which we all have to do—I think what is being considered here is a well targeted plan, and one which could have a very positive consequence, in the near term.

That is when this confidence needs to be restored, in my view. I think it helps the entire country. We are hoping it will help us a little, too, in the Northwest, as my good friend from Washington knows, Mr. Lowry.

Chairman GONZALEZ. Thank you, Mr. Stanton. We are honored also by having the chairman of the full committee, and as you know he took the whole committee over to your State——

Mr. DICKS. We appreciate that, too. That was a very good hearing out there.

Chairman GONZALEZ. It does reflect our concern of conditions over your parts of the country.

Mr. ST GERMAIN. Thank you, Mr. Chairman.

In reference to that hearing in Seattle, I would like to recall that we had some very outstanding but heart rendering testimony. One that struck me particularly was the father of five who worked in the sawmill and had been unemployed for a lengthy period of time.

His unemployment benefits had run out. And he stated that it was rather sad that he could not buy his young son a shirt to play basketball, even though the price was $6 or $7.

But he also stated to the committee that his family would not starve because he had a shotgun and some shells and he did not care if he was arrested if he had to poach, but he would feed his family.

You know, it is incredible.

Mr. DICKS. That says it all.

Mr. ST GERMAIN. That people have to be relegated to such a sad situation. And this man, you know he is not the type of man who fea looking at the want ads and applying for jobs. Quite a few of t witnesses told us about applying for jobs in want ads and they get there at 1 o'clock in the morning to be at the personnel that opened at 8 o'clock in the morning, and already there a few hundred people in line for two or three jobs.

So you are absolutely correct when you state that you have a fear and anxiety. That is shared by many of us. We want to thank you for your presentation.

Incidentally, I think it is on the third page you referred to the fact that in the Seattle area, for example, your realtors tell you that over 70 percent of all sales involve some sort of seller financing. We can only expect creative financing to take us so far.

There is a danger with that seller financing. When the balloon comes due, we have already read of some experiences out in California that are tragic and, as you know, the realtors have been in town the past few days and quite a few have come through my office.

And they expressed the real concern about seller financing, because they are convinced of the fact that when those balloons come due, a lot of them are going to pop and the situation is going to, again, border on the tragic.

I think that perhaps the only way we get around the seller financing problem is to get those interest rates down.

Mr. DICKS. That is right.

Mr. ST GERMAIN. And also to save the thrift industries so that they are up there as providers of mortgage credit. You made reference to that as well in your remarks subsequent to your written testimony, and I agree with you. We are considering legislation in conjunction with the housing bill that would help the net worth of a thrift institution as well as other small commercial banks that are heavily involved in home mortgage financing.

Mr. DICKS. I think it is a dual thing. I think you have to do both or this is not going to work. We also have to adjust the buget to get those out-year deficits down so that interest rates will come down.

Mr. ST GERMAIN. And stay down.

Mr. DICKS. Yes.

Mr. ST GERMAIN. We thank you for your assistance, presentation and your continued assistance.

Mr. DICKS. Thank you. We will do our part on the Appropriations Committee to try to help whatever you do here.

Chairman GONZALEZ. Mr. McKinney.

Mr. MCKINNEY. I appreciate your testimony. I will tell you though I am from the Northeast, that several of your major employers are headquartered in my district and in Stamford, Conn. Among them, Champion International and Continental Group. Champion International, I believe, in your State and in the West, have laid off 3,500 people. They are throwing people out of their executive headquarters in Stamford, also, so it does not affect just your area.

One of the things I have a great deal of trouble with is that I cannot convince the administration that all one has to do is to drive down Main Street in any town in the United States and after you pass the grocery store and perhaps the drug store and maybe a clothing store, there is a lumber yard, there is a pipefitter, there is an electrician, there is an appliance store, there is a car dealer. In fact, the two industries that have the greatest outflow of employment and impact, housing and autos, in the United States of America are on their knees.

Something has to be done about it. Recently I appeared in Williamsburg in front of the Time magazine housing conference. I agreed with you that we are in a situation where we need immediate stimulus. Also I think we need long-range planning and better programs, frankly.

But, what do we do right now has become a major problem. I agree with you that we should compact our timing, do something as quickly as possible. I also suggest to you that if you can have the majority party which has great influence around here——

Mr. DICKS. I would not go too far.

Mr. MCKINNEY [continuing]. And could work on some of our friends on the Ways and Means Committee, it seems to me that there are several bills—I happen to have one but I have no pride of authorship—that are in front of Ways and Means which could give an immediate tax lift to building, either through accelerated depreciation for multifamily builders or through some sort of a tax relief for the home buyer.

I do not suggest we tie ourselves into these programs but I certainly think we could go with them for a year. If, in fact we thought that a year's program of all-savers certificates was of value to the banks, though I have some doubts about that, maybe we should try a year's tax relief to get the hammers flying.

Which is, in essence, all it takes. Once people start picking up their hammers gain, your people will start sawing the wood.

Mr. DICKS. I want you to know that I have cosponsored several bills along the line you have talked about, something in the initial homeownership, IRA account. I agree with you, that that could be just as positive in many respects.

Mr. MCKINNEY. The chairman of this subcommittee, the full chairman, and I, are only too aware of HUD's alacrity. We passed a program called section 8 several years ago that is now haunting us. So I can assure you that we in the authorization committee will try to do all that we can, I know the chairman is dedicated to this. I do not think it will give us as speedy relief as you know you need and I think we need all across this country.

Thank you.

Mr. DICKS. May I say one thing. I appreciate the gentleman's comments. I have some other bad news as well since you come from a State that has a close relationship in another respect with the State of Washington. That is the Boeing Co., with the 757 and 767, are facing very difficult times which will impact the sale of engines, which I am sure the gentleman knows something about.

Mr. MCKINNEY. We are very concerned. It is only a $1 billion payroll in the State of Connecticut for making jet engines. We have already laid off the first 979 people who were just let go about 1 month ago.

Mr. DICKS. Just this Friday United announced that they will defer an order for twenty 757s which is an $800 million order loss. This comes after American deferred on 15 767's. What this does is, at a time when Boeing is paying $150 million a month in finance costs to build those two planes, it could be catastrophic to the company to lose these major orders.

Why are the airlines not ordering? Because nobody is traveling. ;ause interest rates are so high and their earnings are so low.

And, what is important to this committee, because the administration is dramatically reducing the money for the Export-Import Bank. And another thing that we could be doing as part of a countercyclical way to stimulate the economy, is to have that Exim Bank there in a position to help finance exports.

Instead we are contracting there as well, which does not make any sense at all to the American people in my view. It is going to cost us thousands of jobs, in your State and in my State.

Mr. McKINNEY. I would add two other things. Pratt-Whitney has not made a dime on a commercial engine. In fact they have lost money on every commercial engine in the last 4 years because the British company just made a policy that the Rolls Royce people will build all of our engines. The Rolls Royce will set the price. They will finance anybody that has a Rolls Royce engine.

I know this is not housing but it all reflects on the same thing.

Mr. DICKS. It all reflects on the economic malaise we are facing. This committee will be critical to restoring confidence.

Chairman GONZALEZ. Mr. Lowry.

Mr. LOWRY. I do not want to take long, but I just want to compliment my colleague from the State of Washington on an excellent statement and remind the committee that Norm has been working on this housing problem for as long as I can remember. This is not testimony you are making now, Norm, just simply pause of the situation we are in. I want to compliment you for continuing on that.

I do not want to add to all of the bad news, but, I just want to point out that the 13 percent countered unemployment rate in the State of Washington today is before the Boeing law office.

Mr. DICKS. That is right. That is coming next.

Mr. LOWRY. In 1970 and 1971, Mr. Chairman, when the famous billboard that made the front page of national magazine said, "Would the last person leaving Seattle please turn out the lights," our unemployment rate was 10.4 percent. It is now 13 percent and the situation of the commercial airlines has not yet started hitting what is going to happen on the laying offs.

In many areas we are in a depression, not just a recession. There are government responsibilities. There are times when it is time for the Government to step forward and say we do need to do things about this. And housing stimulus, I agree with you and all of the other members of this distinguished committee, who have said that housing stimulus can lead us out of this very bad situation as a nation that we are in.

One other just small point while you are here, while we are talking primarily about private ownership, single family ownership and so on and the importance of that.

Of course there is public housing. And we do have the 1982 pipeline that approved housing, public housing units ready to go at this time that would, I think, get into the job market relatively rapidly.

Of course, on the Appropriation Committee——

Mr. DICKS. We put that bill out.

Mr. LOWRY. You have been working on that. Is that up today?

Mr. DICKS. That will be on the floor today, we reported that out, if we get a rule from the Rules Committee. That bill has been approved by the full committee and is in the Rules Committee.

Mr. LOWRY. You got the rule yesterday, I lost on another rule but you got that one. I would just encourage some active support on that on the House floor today because that can do a lot for us right now.

Thank you, Mr. Chairman.

Mr. DICKS. Thank you for giving us so much time.

Chairman GONZALEZ. We have one more.

Mr. Coyne.

Mr. COYNE. No questions.

Chairman GONZALEZ. Thank you.

We now have Mr. David O. Maxwell, Chairman of the Board of the Federal National Mortgage Association.

Thank you very much, Mr. Chairman. We appreciate very much the fact that you had your testimony with us in time to review. You may proceed as you deem best. You may wish to offer the text of your written presentation for the record, and then summarize, or you may wish to stick to the text.

You may proceed as you see best.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN OF THE BOARD, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. MAXWELL. I will try to accommodate the subcommittee. I know you have a busy schedule and will go through this testimony as quickly as I can.

My name is David O. Maxwell and since May 21, 1981, I have been Chairman of the Board and Chief Executive Officer of the Federal National Mortgage Association. This is my first appearance before this subcommittee in that capacity.

I might say, Mr. Chairman, that 10 years ago, in a memorable year for all of us, I think in particular for you, Mr. Chairman, and the other members of this Subcommittee, I was General Counsel of HUD and worked closely with you and Chairman Barrett and with the staff of this subcommittee.

That was a year in which we had 2.5 million housing starts in the United States. So the atmosphere was very different at that time. Today I appreciate the opportunity to discuss FNMA and the provisions of H.R. 5731, the proposed Housing and Community Development Amendments of 1982, insofar as they affect FNMA.

I would like to cover three major points: the function, importance and problems of the secondary mortgage market in general and FNMA in particular; some of our innovative approaches to cope with these problems and those of the housing industry; and then some specific comments on the sections of H.R. 5731 that directly affect FNMA.

I do not think I need to tell you, Mr. Chairman, the chairman of the full committee, or the other members that this is a very propitious time for these hearings. The housing industry is near collapse. Scores of savings and loans have been merged to avoid failures. Homebuilders are going out of business and construction workers are out of jobs.

Unless the situation improves, the dream of young Americans they can someday live in a home of their own will be just that,

a dream. This subcommittee has a long and distinguished history of seeking and finding ways to make that dream a reality.

The keys to the housing problem are financing and affordability. And as far as financing is concerned, it is FNMA's job to attract much of the money that goes into housing. And to do it as efficiently as possible. With the help of this subcommittee, the Congress and other segments of the housing industry, we intend to do that job.

Now, as you know, the Federal National Mortgage Association, known as FNMA, began in 1938 as a subsidiary of the Reconstruction Finance Corporation, chartered by the Federal Housing Administrator. After several reorganizations, President Lyndon Johnson proposed in 1968 that FNMA become a private corporation. The Congress created both FNMA and the Government National Mortgage Association, GNMA, which is a part of HUD.

As a private corporation, FNMA is listed on the New York Stock Exchange and is supervised in certain respects by the Secretary of Housing and Urban Development and the Secretary of the Treasury. We have a 15-person Board of Directors of which 10 are elected by the 29,000 holders of our 59 million shares of stock, and the remaining 5 are appointed by the President.

When we became private we paid the U.S. Treasury $216 million for the stock the Government held and for the Government's share of retained earnings. For most of our existence, we have operated at a profit. We have paid $950 million in Federal taxes since we became private, and we made payments in lieu of taxes between 1954 and 1968, when we were owned in part by the Federal Government.

Our purpose is to provide assistance, liquidity and stability to the home mortgage market. We operate in the secondary market. We purchase mortgages from financial institutions such as mortgage bankers, savings and loan associations and commercial and savings banks and thus provide them money to lend people to buy homes.

We have obtained our own money to buy those mortgages largely through short and medium term borrowing.

Our service as a financial intermediary improves the efficiency of the housing finance market, thus permitting housing to compete with other capital needs for investment dollars. For years we raised the money to buy mortgages by borrowing short term at interest rates that were traditionally lower than long term mortgage rates.

Since 1978 this has been reversed. Short term interest rates have generally been higher than long term interest rates. Furthermore, overall interest rates have climbed to unprecedented levels. As a result, the rates FNMA has had to pay to roll over its debt have far exceeded the returns on the mortgages in the portfolio.

Today, FNMA holds $62 billion in mortgages, 1 of every 20 home mortgages in America. Two-thirds of these are FHA and VA mortgages, of which $35 billion are single-family mortgages with an average outstanding balance of $23,425.

I would like to emphasize that point, Mr. Chairman. FNMA has been providing a market for FHA and VA mortgages which otherwise would not have been sold. Therefore, they would not have been made. Without FNMA those people would not have had the

financing to buy homes, because when FHA and VA mortgages could not be put into GNMA pools, FNMA was there to buy them. That is how we accumulated most of that $41 billion portfolio.

These mortgages are assumable and they usually remain on our books for the entire life of the mortgage, or 30 years.

The average outstanding balance of the conventional mortgages that we have purchased is $42,905. Some $15.5 billion of FNMA's mortgage portfolio yields less than 8.5 percent. Some $6 billion of our mortgages yield 7 percent or less.

We have $59 billion in debt outstanding. Much of that debt is held by savings and loan associations and banks. The spread between the average return on FNMA's mortgages and the average costs of its debt turned negative in January 1980 and is now a negative 1.43 percent. As a result, our net loss after taxes in 1981 was more than $190 million.

FNMA's ability to take immediate action to help remedy the problem it faces is limited. During periods of tight credit, some private companies can postpone their borrowing, but we cannot. We have to borrow to refinance the debt that supports our mortgage portfolio and to acquire more funds to channel to the mortgage bankers, savings and loan associations, and savings and commercial banks that are still making mortgages.

Our borrowing in June 1981, my first full month as FNMA's chief executive officer, dramatically illustrates our quandary. We had to pay 14.6 percent to roll over long-term debt that had cost 7.76 percent. So we almost doubled our interest payments on that debt. In the same month we had to pay 17.39 percent to roll over $3.6 billion in short-term debt, with a prior average cost of 16.5 percent.

So just those debt rollovers in June 1981, added about $100 million to our annual interest costs.

Now, the traditional way we have done business made us especially vulnerable in this era of high interest rates. At the same time, however, it is important to remember that by doing business that way, and by buying so many FHA and VA mortgages, FNMA has been carrying out its congressional mandate. And we are a key to maintaining a stable flow of money into the mortgage sector.

I do not need to tell this subcommittee that the housing industry is extremely vulnerable to high interest rates. As Congressman Dicks pointed out, it is not just the housing industry, it is all of the things that depend on the housing industry, the lumber producers, plumbers, and the rest who are completely at the mercy of what is happening in housing.

Our mortgage purchases have, in the past, during our history as private corporation, helped many times to cushion the downturns in the housing market.

During the troubled months of 1981, dispite our own problems, we committed to purchase $9.3 billion in mortgages. We purchased $6.1 billion of newly originated mortgages in 1981 and $2.3 billion of these mortgages were FHA/VA. Of the $6.1 billion, we bought $5.1 billion after I became chairman in May.

This total of $5.1 billion included $1.7 billion of FHA/VA mortgages, bought at a time when other investors had withdrawn from the secongary market and GNMA volumes decreased.

The average balance of all the single-family mortgages we purchased in 1981 was $49,457. I think it is just to say that at many times during 1981 we were the only game in town in the secondary market.

The next section of my testimony is entitled "Innovations in FNMA Operations." I will skip over this, Mr. Chairman, except to say that we have endeavored to help ourselves while we are helping housing. We have influence over the asset side of our balance sheet. We have been endeavoring to buy assets—just as we bought the $6.1 billion of mortgages during 1981—which will enable us to offset these terrible losses that we are suffering and at the same time give real support to the mortgage market.

I invite the subcommittee's attention particularly to the discussion on pages 7, 8, and 9 of my prepared statement regarding our mortgage backed securities program. This could be the most important innovation in housing since the FHA loan came along. These securities are a divice for channeling money from the pension funds safely into the housing market. And we are well along with their development.

We have addressed the affordability question by purchasing mortgages involving buydowns. These are mortgages for which the builder buys down the interest rate to enable the buyer to purchase the house. We have done that with adjustable rate mortgages; we have done it with graduated payment mortgages.

We have tried to help the housing market in every way we can. In the multifamily field, as it says at the top of page 10 of my prepared statement, we have another program which we initiated in the city of Atlanta. There we pledged our FNMA-owned FHA mortgages to purchasers of an issue of tax exempt mortgage revenue bonds. The proceeds of those bonds will be used to build and improve low- and moderate-income multifamily housing in the city of Atlanta. The income limit for the renters in those multifamily projects is $38,000 and 20 percent of the renters must have incomes that do not exceed 80 percent of the median income in the Atlanta area. This is another way in which we are trying to aid housing.

Despite these efforts, FNMA will continue to face financial problems for the immediate future because there are two factors beyond our control. The first is our portfolio. We are burdened by $41 billion of mortgages that yield less than 10 percent. And the second is that the interest rates that dictate what we have to pay to borrow are out of our control as well. Those interest rates simply must come down in order to enable us to continue our pr
and, of course, to enable the housing industry and the savi
loan business to revive.

Let me turn if I may to the provisions of H.R. 5731 t
FNMA. I want to emphasize that the reduction of our ne
caused by our losses increases our debt to equity ratio, or
When our leverage goes up, our borrowing costs go up. W
borrowing costs go up, we have to require higher interest r
the mortgages we buy. That, in turn, is passed on the t
buyers.

So it is very important for FNMA to be
by acquireing as many high yielding
must do this in order to maintain our

for FHA/VA mortgages. That strategy is really the key to our present viability.

H.R. 5731 would restrict FNMA's authority to purchase second mortgages from savings and loan associations and other primary lenders. Currently under its charter FNMA has the authority to purchase either first or second mortgages or the sum of both, in an amount up to the statutory ceiling, $107,000 for a single-family home.

The proposed legislation would limit FNMA's authority to purchase second mortgages to $40,000 for a single-family home and $60,000 for a two-family home. It would also prohibit FNMA from purchasing second mortgages unless the individual or family used the funds acquired through the second mortgage to improve the mortgaged home or buy the mortgaged home.

These provisions stem from an understandable concern that FNMA's second mortgage activities might somehow be inconsistent with its congressional mandate to help provide adequate housing for low- and moderate-income families.

But quite the contrary, I believe that our actions are not only consistent with our charter, but are essential if FNMA is to fulfill its overall congressional mandate to provide a secondary market for housing in America, including low- and moderate-income housing.

Our program of purchasing second mortgages helps the housing market, is attractive to homeowners and savings and loan associations and provides FNMA with a source of funds to narrow the adverse spreads that have produced our current losses.

We have now purchased second mortgages totaling approximately $249 million. The average amount of these second mortgages has been $20,600. The average net yield they produce for FNMA is 17.5 percent.

Now while the average mortgage amount has been far below the proposed H.R. 5731 limit, some individual second mortgage purchases have exceeded those limits. This is particularly true in the Western and Southwestern regions of the United States and in some cities like Washington, D.C., where housing prices have increased sharply over the past decade.

The increased home prices in these areas leave a wide gap between the current market value of the house and the unpaid balance of an existing first mortgage with a low interest rate.

Buyers of these houses naturally wish to assume the low interest rate first mortgages. The opportunity to do so is often the only way they can afford to buy the house. So in such circumstances, it is imperative that savings and loan associations and other primary lenders be able to provide substantial second mortgages to home buyers. The continued capacity of primary lenders to do this often depends on FNMA's ability to purchase those second mortgages in the secondary market.

There are no limits on the sizes of second mortgages that savings and loan associations can make. It makes sense for FNMA to be in the same position so it can provide a secondary market for such loans.

I also believe that this subcommittee should not require that ›ney from second mortgages be used only to improve or buy

homes in order that such mortgages be eligible for purchase by FNMA in the secondary market. No such restriction limits savings and loan association and other primary lenders and FNMA should be in a position to support them.

There are other strong public policy arguments that support our position. For FNMA to restrict every American homeowner whose second mortgage it holds to use the funds from that mortgage for home improvements or a home purchase, would require a bureaucracy. We would need auditors and accountants to make sure that the money was used to fix the roof, rather than send a son or daughter to medical school, pay for a sick mother, or help a small businessman in a recession.

More important than that, is it fair to the American citizens who have put their life savings in their homes, to prevent them from taking advantage of this investment by using it to send a talented child through college or, after retirement, to take a vacation the family had planned during their working years?

The cost of policing this restriction will ultimately be borne by the American homeowner. The restriction itself could have the unintended result of discouraging some Americans from investing in their own homes since it would mean that their savings would accumulate in an equity they could not use.

So we provide liquidity to lenders, help for the beleaguered homeowners and aid to hard-pressed citizens with our second mortgage program and I urge you to eliminate the second mortgage provisions in H.R. 5731.

The other section that pertains to FNMA in this bill would not permit us to buy a participation interest in a conventional first mortgage where the total amount of the mortgage exceeded the statutory limit, currently $107,000 for a single family home. I believe that this provision stems in part from the subcommittee's concern—and a justified concern—that we continue to devote our efforts to the low- and moderate-income segment of the housing market.

Our position has been that the existing Charter Act gives us the authority to purchase a portion of a mortgage up to the ceiling of $107,000, even though the mortgage total may exceed that amount. The subcommittee's staff attorneys disagree with that. They believe that the Charter Act limits the total size of the mortgage to $107,000, whether we purchase it on a participation basis or a whole loan basis.

It is interesting that we have purchased 26,000 participations in mortgages since we began our program last year and our quick check in preparation for this testimony indicated that only 37 of those 26,000 are participations in mortgages where the total mortgage amount exceeds $107,000.

Since there is an honest difference of opinion, out of respect for this subcommittee and its staff FNMA will not purchase participation interests in conventional first mortgages where the total mortgage amount exceeds the statutory limit of $107,000 for a single-family house, until the Congress has acted or has declined to act on this matter.

We should not be distracted from the importance of tl
and its sound basis as public policy. I urge this subc r

consider our arguments in terms of FNMA's congressional mandate, to support all housing in America, including low- and moderate-income housing.

Here again, the H.R. 5731 restriction unreadistically inhibits FNMA's activities in certain sections of the country. It places a restriction on FNMA that Congress has not imposed on savings and loan associations and other primary lenders, thereby inhibiting FNMA's ability to support these lenders. It would keep FNMA out of a market that can provide funds to strenghten its capacity to support low- and moderate-income housing, and to continue to purchase FHA and VA loans.

We urge the committee to provide maximum flexibility to FNMA, to permit FNMA's activities in the secondary market to mirror the activities of the savings and loan associations and other primary lenders. To achieve that objective the legislation should lift the mortgage limits completely.

We are subject to the statutory mandate to support housing and to make mortgage purchases related to the national goal of providing adequate housing for low- and moderate-income families. We believe we can best fulfill that mandate if we have flexibility, particularly in such a rapidly changing financial world. It is the function of the Congress to impose such a mandate on FNMA.

I would hope, Mr. Chairman, that you would agree that it is not appropriate for the Congress to try to set limits of $40,000 or $60,000 or $107,000 or $127,000. Those limits are truly a function of the market and the desires and needs of the American home buyer and are best set by them.

The housing industry is at the heart of the economy in this country. I know how concerned both the chairman of the full committee and the chairman of this subcommittee are with the situation of the savings and loan institutions and the housing industry.

As to the secondary market, FNMA feels that at an appropriate time the committee will want to look at the whole operation of the secondary market and the Federal role in that market. We intend to aid those deliberations by sponsoring a national conference on the secondary mortgage market later this year. We hope you, Mr. Chairman, your colleagues on the committee and your able staff will participate in this effort.

I am very grateful for the opportunity to appear here this morning. I will be glad to answer any questions.

[Mr. Maxwell's prepared statement, on behalf of the Federal National Mortgage Association, follows:]

Statement Of
DAVID O. MAXWELL,

Chairman and Chief Executive Officer,
Federal National Mortgage Association

Before The
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
Of The
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

March [illegible], 1982

Mr. Chairman and Members of the Committee:

My name is David O. Maxwell. Since May [illegible], 1981, I have been Chairman of the Board and Chief Executive Officer of the Federal National Mortgage Association. As this, my first appearance before the Subcommittee, I appreciate the opportunity to discuss FNMA and the provisions of H.R. [illegible], the proposed Housing and Community Development Amendments of 1982, that affect FNMA.

My testimony will cover three major points:

- The function, importance and problems of the secondary mortgage market in general, and FNMA in particular.
- Some innovative approaches FNMA is taking to cope with its problems, and those of the housing industry.
- Specific comments on the sections of H.R. [illegible] that directly affect FNMA.

This is a propitious time for your hearings, Mr. Chairman. The American housing industry is near collapse. Scores of savings and loan associations have been merged to avoid

failure. Homebuilders are going out of business and construction workers are out of jobs. Unless the situation improves, the dream of young Americans that they can someday live in a home of their own will be just that, a dream. This Committee has a long and distinguished history of seeking and finding ways to make that dream a reality.

The keys to the housing problem in America are financing and affordability. Our nation has the capacity to produce building materials, ample land on which to build, gifted architects and experienced craftsmen, and millions of families who seek housing they can afford. The most expensive part of an American house today is the cost of the money needed to build and buy it. It is FNMA's job to attract much of that money to housing, as efficiently as possible. With the help of this Committee, the Congress, and the other segments of the housing industry, we intend to do that job. For financing housing is what the Congress chartered FNMA to do; it's what we're all about.

The Federal National Mortgage Association

The Federal National Mortgage Association -- also known as FNMA or Fannie Mae -- began in 1938 as a subsidiary of the Reconstruction Finance Corporation, chartered by the Federal Housing Administrator. After several reorganizations, the Congress in 1968 separated FNMA into two distinct organizations:

FNMA and the Government National Mortgage Association (GNMA or Ginnie Mae). FNMA became a private corporation, listed on the New York Stock Exchange and supervised in certain respects by the Secretaries of Housing and Urban Development, and Treasury. It has a 15 person Board of Directors. Ten are elected by the 29,000 holders of its 59,000,000 shares of stock; the remaining five are appointed by the President. GNMA was established as part of the Department of Housing and Urban Development to carry out government-subsidized mortgage programs and to help provide financing for FHA and VA mortgages.

When FNMA became private, it paid the U.S. Treasury $216 million for the stock the government held and for the government's share of retained earnings. FNMA's secondary market activities were limited to FHA/VA mortgages until 1971, when the Congress authorized it to purchase conventional mortgages as well. For most of its existence, FNMA has operated at a profit. It has paid $950 million in federal taxes.

FNMA is chartered by the Congress to provide assistance, liquidity and stability to the home mortgage market. FNMA operates in the secondary mortgage market. It purchases mortgages from financial institutions, such as mortgage bankers, savings and loan associations, and commercial and savings banks, to provide them money to lend people to buy homes. FNMA has obtained the money to purchase these mortgages largely through short- and medium-term borrowing in the capital markets.

FNMA's service as a financial intermediary improves the efficiency of the housing finance market, thus permitting housing to compete with other capital needs for investment dollars. Its operations transform mortgages from small, illiquid and local investments into corporate paper which attracts money to housing. The national scope of FNMA's operations has increased the flow of mortgage funds among geographic regions of the nation. FNMA has also worked with GNMA to increase the availability of low and moderate income housing, with little or no impact on the federal budget.

For years, FNMA raised the money to buy mortgages by borrowing short-term at interest rates that were traditionally lower than the long-term mortgage rates. Since 1978, this situation has been reversed: short-term interest rates have generally been higher than long-term interest rates. Furthermore, overall interest rates have climbed to unprecedented levels. As a result, the rates FNMA has had to pay to roll over its debt have far exceeded the returns on the mortgages in FNMA's portfolio.

Today, FNMA holds $62 billion in mortgages -- one of every 20 home mortgages in America. Two-thirds of these, some $41 billion, are FHA and VA mortgages. Of these, $35 billion are single-family mortgages, and their average outstanding balance is $23,425. The average outstanding balance of conventional mortgages that FNMA holds is $42,905. Some $16.5 billion of FNMA's mortgage portfolio yields less than 8-1/2 percent.

FNMA has $59 billion in debt outstanding. Much of that

debt is held by savings and loan associations and banks. The spread between the average return on FNMA's mortgages and the average cost of its debt turned negative in January 1980 and is now a negative 1.43 percent. As a result, our net after tax loss in 1981 was more than $190 million.

FNMA's ability to take immediate action to help remedy the problem it faces is limited. During periods of tight credit some private companies can postpone borrowing until interest rates fall, but FNMA cannot. It must borrow both to refinance the debt that supports its mortgage portfolio, and to acquire more funds to channel to the mortgage bankers, savings and loan associations, and savings and commercial banks. The Charter Act explicitly requires that FNMA purchase mortgages "within the range of market prices" and that FNMA "operations should be fully self supporting." Quite simply, when the Congress chartered FNMA in 1968 and mandated that it assist housing by building a strong secondary mortgage market, no one contemplated the high interest rate conditions that have persisted since 1978.

Our borrowing in June of 1981, my first full month as FNMA's Chief Executive Officer, dramatically illustrates our quandary. We had to pay 14.6 percent to roll over long-term debt that had cost 7.76 percent, almost doubling our interest payments on that debt. In the same month, we had to pay 17.35 percent to roll over $3.6 billion in short-term debt with a prior average cost of 16.3 percent. FNMA's rollovers in June 1981 added more than $100 million to our annual interest costs.

FNMA's traditional way of doing business made it especially vulnerable in this era of high interest rates. Under its free-market auction system, FNMA made firm commitments for either four or twelve months to buy mortgages at set yields. The lenders holding the FNMA commitment could at any time during the period elect whether they wanted to deliver their mortgages. Lenders used FNMA commitments to hedge against interest rate increases. They sold mortgages to FNMA when interest rates went up. If interest rates stayed steady or decreased, lenders could shop around for a better price for their mortgages.

FNMA became the interest rate insurer because it was perceived during the 1970's as the purchaser of last resort. FNMA was expected to purchase mortgages when no one else was willing or able to do so, and it did just that. As a result, FNMA purchased a large volume of mortgages at relatively low yields during periods of rising interest rates and tight credit. It received few mortgages for purchase when interest rates were declining and credit was easily available.

FNMA is a key to maintaining a stable flow of money into the mortgage sector. The housing industry is extremely vulnerable to high interest rates. During periods of credit shortages and high interest rates, housing construction declines, building tradesmen are unemployed, and many Americans are unable to buy homes. In the past, FNMA's extensive mortgage purchases during these periods have helped prevent a collapse in housing.

During the troubled months of [illegible] we committed to purchase $[illegible] million in mortgages. We actually purchased $[illegible] million of newly originated mortgages, of which $[illegible] million were FHA/VA mortgages. Of the $[illegible] million, we bought $[illegible] million after I became Chairman. This included $[illegible] million of FHA/VA mortgages at a time when other investors had withdrawn from the secondary market and GNMA volumes were sharply reduced. The average amount of all single-family mortgages we purchased during [illegible] was $[illegible]. For much of [illegible] FNMA was called "the only game in town" in the secondary market.

Innovations in FNMA Operations

FNMA has embarked on a vigorous program to help housing while helping itself. We have initiated a program to sell mortgage-backed securities in order to expand the linkage between the securities market and conventional mortgages. In the last few months, we have committed to buy more than $[illegible] billion in adjustable rate mortgages. Many of these commitments were made in special arrangements to help builders sell houses.

FNMA's new mortgage-backed security program constitutes a major change for conventional mortgage financing, comparable in importance to the introduction of the FHA long-term, fixed rate mortgage. Mortgage-backed securities provide a vehicle for raising funds in capital markets by changing mortgages into uniform liquid investments. The securities are issued by FNMA and backed by mortgage pools FNMA has bought from thrifts

and other primary market lenders for this purpose. FNMA guarantees timely payments of principal and interest to investors in these securities. The term of the securities varies depending on investor preferences; the lives of the mortgages behind the securities are matched appropriately.

Mortgage-backed securities are advantageous for all involved. For the thrifts and others who originate mortgages, the mortgage-backed security offers an alternative to borrowing short in order to lend long. That means less risk from volatile interest rates. It also provides increased liquidity. Indeed, the first $5.5 billion of these securities issued by FNMA were backed by low-yielding mortgages FNMA acquired from thrifts' portfolios, giving these lenders liquidity when they most needed it. These primary lenders will continue to make money by originating mortgages and will receive a steady stream of income from FNMA for servicing the mortgages in the pools.

The mortgage-backed security is also attractive from an investor's standpoint. It provides a reliable return from real estate, packaged in a security form familiar to capital markets. Investors do not need real estate expertise to buy these securities and can sell them if necessary. FNMA's standards and its full guarantee assure a regular, secure return. FNMA's mortgage-backed security provides a key to attracting money from pension funds to housing. For example, FNMA's conventional mortgage-backed security is being used by the Maryland State

Retirement System to fund home mortgages in Maryland. Loyola Federal Savings and Loan of Baltimore will issue $20 million in mortgages, almost all for new homes in Maryland. It will exchange these mortgages for $20 million of the FNMA conventional mortgage-backed securities, which the Retirement System has agreed to purchase. I am confident that the Maryland fund is only the first of many state pension funds that will turn to these FNMA securities as the means of using their resources to provide housing and jobs for our citizens.

Finally, the mortgage-backed security is important for FNMA's financial health. FNMA is paid a small fee by lenders who pool mortgages that back the securities. FNMA also gets a small percentage difference between the return on the mortgages and the payout on the security. And FNMA is not exposed to the refunding risk associated with borrowing short to buy long.

FNMA has tried to address the important affordability issue by purchasing mortgages involving buydowns and pledged accounts. We have virtually completed design of a mortgage that combines the attractive features of graduated payment and adjustable rate mortgages. We have opened our portfolio to purchase of mortgages involving manufactured housing and leased land -- two other approaches to housing affordability.

FNMA has sought ways to use its existing mortgage portfolio to fund housing and improve our financial position. As a result, we have arranged to pledge the cash flow from a

pool of FNMA-owned FHA mortgages to purchasers of an issue of tax-exempt mortgage revenue bonds, whose proceeds will be used to build and improve low and moderate income multi-family housing in Atlanta, Georgia. We hope this will be the prototype for similar arrangements elsewhere.

These are some of the ways that FNMA has sought to be an innovative and substantial force in housing during the past year. We are proud of our record and our results.

We have demonstrated that we can improve the asset side of our balance sheet. During 1981 FNMA lifted the average return on its portfolio from 9.24 to 9.85 percent. For the last two quarters of that year we bought mortgages with returns higher than our debt costs. Furthermore, two of our innovations, conventional mortgage-backed securities and adjustable rate mortgages, will permit us over time to better match our assets to our liabilities. But there are limits to what we can do by ourselves.

Despite these efforts, FNMA will continue to face financial problems for the immediate future because of two factors beyond our control. We cannot control the interest rates we must pay on our debt. The economy dictates that side of our balance sheet. In addition, FNMA's portfolio is burdened by $41 billion of mortgages that yield less than ten percent. Many of these are assumable FHA/VA mortgages acquired over the years. These mortgages are not being paid off; they will continue to drag down earnings for years. We can partially offset these problems

by acquiring high yielding assets. If we do not, FNMA's losses will continue to reduce its net worth and increase its debt-to-equity ratio, or leverage. When our leverage goes up, so do our borrowing costs. Higher borrowing costs for FNMA translate into higher mortgage rates for homebuyers. Therefore, to keep our rates down and to maintain our ability to hold and purchase FHA/VA mortgages, we need more higher yielding assets. This strategy is a key to our present viability.

H.R. 5731

Let me turn to the provisions of H.R. 5731 that would apply to FNMA.

H. R. 5731 would restrict FNMA's authority to purchase second mortgages from savings and loan associations and other primary lenders. Currently, under its charter FNMA has the authority to purchase either first or second mortgages, or the sum of both, in an amount up to the statutory ceiling -- $107,000 for a single family home.

The proposed legislation would limit FNMA's authority to purchase second mortgages to $40,000 for a single family home and $60,000 for a two-family home. It would also prohibit FNMA from purchasing second mortgages unless the individual or family used the funds acquired through the second mortgage to improve or buy the mortgaged home.

These provisions stem from a concern that FNMA's second mortgage activities are somehow inconsistent with that portion of its Congressional mandate to help provide adequate housing for low and moderate income families. Quite the contrary, I believe that our actions are not only consistent with our Charter, but are essential if FNMA is to fulfill its overall Congressional mandate to provide a secondary market for housing in America, including low and moderate income housing.

Our program of purchasing second mortgages helps the housing market, is attractive to home owners and savings and loan associations, and provides FNMA with a source of funds to narrow the adverse spreads that have produced our current losses.

FNMA has purchased second mortgages totaling approximately $249 million. The average mortgage amount has been $20,600; the average net yield to FNMA is 17.05 percent. While the average amount has been far below the proposed H. R. 5731 limits, some individual second mortgage purchases have exceeded those limits. This is particularly true in the western and southwestern regions of the United States, and in some cities, like Washington, D.C., where housing prices have increased sharply over the past decade. The increased home prices in these areas leave a wide gap between the unpaid balance of an existing first mortgage, which has a low interest rate and is usually assumable, and the current market value of the house.

Buyers of these houses naturally wish to assume the low interest rate first mortgage; indeed, the opportunity to do so is often the only way they can afford to buy the house. In such circumstances, it is imperative for savings and loan associations and other primary lenders to be able to provide substantial second mortgages to home buyers. The continued capacity of primary lenders to do this often depends on FNMA's ability to purchase those second mortgages in the secondary market. There are no limits on the size of second mortgages savings and loan associations can make, and it makes sense for FNMA to be in the same position in the secondary market for such loans.

We also believe that this Committee should not require that money from second mortgages be used to improve or buy homes in order to make such mortgages eligible for purchase by FNMA in the secondary market. Here, too, no such restriction limits savings and loan associations and other primary lenders, and FNMA should be in a position to support them.

Other strong public policy arguments support our position. For FNMA to try to restrict every American homeowner whose second mortgage it holds to use the funds from that mortgage only for home improvements or a home purchase would require a bureaucracy of enormous proportions. We would need auditors, accountants, investigators, and a host of additional personnel to make sure that the money was used to fix the roof, rather than send a son or daughter to medical school, pay for a sick mother in a nursing home, or help a small businessman through

a recession. How would we trace the funds? Even if the Congress wanted FNMA or the primary lender to establish such a bureaucratic apparatus, is it fair to the American citizen who has put his life savings in his home, not to be able to take advantage of this investment to send a talented child through college, or after retirement just take a vacation the family had planned during their working years?

The cost of policing this restriction will ultimately be borne by the American homeowner. The restriction itself could have the unintended result of discouraging some Americans from investing in their own homes if their savings were to accumulate in an equity they could not use.

In short, FNMA's unrestricted ability to purchase second mortgages provides needed liquidity to lenders, help for beleagured homeowners in selling homes, and aid to hard-pressed citizens whose savings are tied up in their homes. It preserves the attraction of home ownership by making sure it is not a straightjacket, and it helps FNMA get higher yielding assets so it can meet its responsibilities. I, therefore, urge the Committee to eliminate the second mortgage provision of H.R. 5731.

The proposed bill has another section which would not permit FNMA to buy a participation in a conventional first mortgage where the total amount of the mortgage exceeded the statutory limit -- $107,000 for a single-family home. In part this provision stems from concerns similar to those

that prompted the proposed limits on FNMA's purchase of second mortgages. But this provision is also sparked by a disagreement among the Committee staff and FNMA lawyers.

FNMA's position is that the existing charter gives it authority to purchase a share of a mortgage up to the statutory ceiling of $107,000, even though the total mortgage may exceed that amount. Committee staff attorneys believe that the existing charter limits FNMA to participating in portions of mortgages only where the total amount of the mortgage does not exceed $107,000 for a single-family home.

In fact, Mr. Chairman, FNMA has purchased some 26,000 participations since we began our program late last year. A quick check in preparation for my testimony indicates that only 37 of those are participations in mortgages where the total mortgage amount exceeds $10',000.

Since there is an honest difference of opinion, however, out of respect for this committee and its staff, FNMA will not purchase participations on conventional first mortgages where the total amount of the mortgage exceeds the statutory limit ($107,000 for a single-family house) until the Congress acts or declines to act on this matter. We should not be distracted from the importance of this program and its sound basis as public policy. I urge this committee to consider our arguments in terms of FNMA's Congressional mandate to support all housing in America, including low and moderate income housing.

Here again, the H.R. 5731 restriction unrealistically inhibits FNMA's activity in certain sections of the country,

like the west and southwest, and in certain cities. It places a restriction on FNMA that the Congress has not imposed on savings and loan associations and other primary lenders, thereby inhibiting FNMA's ability to support these lenders. It would keep FNMA out of a market that can provide funds to strengthen its capacity to support low and moderate income housing, and to continue to purchase FHA and VA loans.

We urge the Committee to provide the maximum flexibility to FNMA, to permit FNMA's activities in the secondary market to mirror the activities of the savings and loan associations and other primary lenders. To achieve that objective, the legislation should lift the mortgage purchase limits completely.

FNMA is subject to the statutory mandate to support housing and to make mortgage purchases "related to the national goal of providing adequate housing for low and moderate income families . . . ." We believe we can best fulfill that mandate if we have flexibility, particularly in such a rapidly changing financial world. It is the function of the Congress to impose that mandate on FNMA. I would hope, Mr. Chairman, that you would agree that it is not appropriate for the Congress to try to set limits of $40,000 or $60,000 or $107,000 or $127,000. Those limits are truly a function of the market and the desires and needs of the American homebuyer and are best set by them.

The housing crisis has been felt throughout our economy -- affecting buyers, builders, manuacturers and suppliers, realtors and mortgage lenders. It has left the housing finance

system in disarray. We must find effective temporary solutions to the current situation, but we must be careful not to make hasty and potentially dangerous long-term decisions in the current atmosphere of crisis. FNMA intends later this year to sponsor a national conference on the secondary mortgage market. We are hopeful that you, Mr. Chairman, your colleagues on the Committee, and your able staff will participate in this effort.

Mr. Chairman, I deeply appreciate the opportunity you have given me to testify before this Committee. In my first year as head of FNMA, I have brought in a new team. We are working hard to fulfill our responsibilities under the charter from the Congress. We look forward to working with you and with all others interested in an America where every-one who wants to buy his own home can afford to do so.

Chairman GONZALEZ. Thank you very much, Mr. Maxwell, for a tremendously very good statement. And your interest and time to be here this morning. We appreciate your invitation for a future conference. As you know, at this point on that particular subject matter, we have shared jurisdiction between this particular subcommittee on Housing and Community Development and the full committee chairmen's subcommittee that he chairs—the Finanical Institution Supervision, Regulation and Insurance Subcommittee. So that we have been proceeding jointly, in fact, in these hearings we have taken in his emergency bill with respect to the thrift institutions and, in fact, that is what is really current before us, the two bills.

Not only H.R. 5731.

But I am deeply grateful. Also, I compliment you on your role as chairman and the innovative approaches that you have used and thought of in order to combat these rather new and unprecedented conditions. I think you have done a very good job.

Mr. MAXWELL. Thank you, Mr. Chairman.

Chairman GONZALEZ. I think the record ought to reflect that.

I have two questions. You briefly described in your testimony FNMA's new conventional market-backed securities program. If the administration is successful in reducing the GNMA market-backed securities program to $38.4 billion, and I am afraid we have to assume that they will be successful the way the political situation is, our projections indicate that this level would not be sufficient to provide the necessary secondary market support for our two FHA and VA programs.

If the GNMA level is established at the levels proposed by the administration, will FNMA adopt its mortgage-backed program to include FHA mortgages, in order to meet the unfulfill[illegible]?

Mr. MAXWELL. Mr. Chairman, on the GNMA point, GNMA has been a tremendously successful program. Over $130 billion of GNMA securities are outstanding and they have financed housing for a great many American families. The issue of the future of GNMA, I think, is one of the subjects that the subcommittee might want to address in a thorough hearing later in the year or early next year on the whole shape of the secondary market in the future.

If the level which is in fact adopted for GNMA is inadequate to handle the market, certainly FNMA would endeavor to take up that slack and we would be receptive to undertaking a program of guaranteeing securities backed by pools of FHA and VA mortgages. The interest cost would probably be higher than that for GNMA securities because we do not have the full faith and credit of the United States behind our securities. But the FNMA name is a good one and we could probably successfully launch such a program.

Chairman GONZALEZ. Thank you very much.

The second question, and it has to do with I think a very properly raised issue that as you say on the legal aspect, the staffs do not agree at all. The staffs have been in consultation for instance with myself and in the drawing up of the bill we had to approach it from the standpoint of what we feel is consistent with the original charter purpose for this institution.

The questions are: What assurances does the Congress have from FNMA other than—I must say to me it means a lot, the absolute categorical statement you made and that you have offered with respect to the pending action and policy until the Congress does address the issues squarely.

Other than the good faith commitment from you, if the current market limits in FNMA's charter are removed, you will continue to meet the needs of the middle segment of the housing market. Again, especially FHA and VA, that is a great area of concern to me.

As I understand it, even now FHA and VA loans are not as desirable for FNMA, for purchase, because of their assumability feature. If the limits are removed, is it reasonable to expect that FNMA would attempt to put as much of its resources as possible into the higher priced mortgages? Yet, I assume, that you have only a finite amount of mortgage resources available.

So, ultimately we have to ask this question: What assurances do we, or does the Congress have that you will not use your limited resources to purchase higher yielding mortgages at the expense of the middle segment of the market and particularly FHA and VA?

Mr. MAXWELL. Well, Mr. Chairman, I recognize the subcommittee's concerns and I certainly respect them and I think that the subcommittee is quite correct in asking us for such assurances. We take very seriously the fact that we are congressionally chartered. We take seriously the provisions of the charter which governs us.

That charter provides not only that we will take into account the low- and moderate-income segment of the housing market, but it also specifically addresses the question of our support for the FHA and VA market.

W[illegible] intend to comply with the requirements of our Charter Act. [illegible] is No. 1. Our respect for the law, our respect for the Congress,

and our desire to comply with what we are specifically mandated to do mean that we will continue to support housing for low- and moderate-income persons and the FHA/VA mortgage market.

The second reason is based more on economics, if you will. From a market standpoint, the overwhelming market for operations like FNMA's, which is a high-volume operation, is not in the higher priced end of the market. We have done some studies in connection with this participation issue to try to determine how much of the market we are not able to serve as a result of the limitation.

It is not a great part of the market. It varies, of course, from State to State. In California it is a much larger segment of the market. In Texas it is about 10 or 12 percent of the market. But FNMA's whole operation is based on volume. We can get access to the credit markets. We are not limited in our ability to buy the mortgages that we need to buy.

Our position is that actually, both our ability to serve the low- and moderate-income area and our ability to buy FHA and VA mortgages would be enhanced if we had more flexibility to support those operations. Although FNMA does not impose varying yield requirements, a higher balance mortgage generally carries a higher yield. Our ability to purchase larger loans or participations in larger loans would help our financial picture by enlarging the total amount of high-yielding assets we can buy. This will increase the average yield on our mortgage portfolio and help to reduce the negative spread we are experiencing.

To the extent that we can help our own income, we can lower the interest we will have to pay for our debt and thus will be able to lower the yields that we have to require for low and moderate income and other mortgages sold to us.

Chairman GONZALEZ. Well, I am deeply grateful to you, because I think—well there is no question in my mind how I feel, as long as you are the administrator. But as always, I think what we, in the legislative endeavor, must bear in mind is that we have to draft the legislation in such a way that we do not assume it will be angels, like yourself, who will be administrating, but the devil incarnate.

That is the only reason. Your testimony is very impressive in behalf of flexibility and freedom in that respect.

Mr. Stanton.

Mr. STANTON. Thank you very much, Mr. Chairman.

Chairman MAXWELL. I want to reiterate what the Chairman has said with regard to your performance on the board of the corporation. It is hard to realize you have been onboard less than a year.

Mr. MAXWELL. I do not have any trouble realizing it.

Mr. STANTON. Well, I really mean that. When I was listening to you read your statement, it reminded me of our relationship with the Federal Reserve Board. You are both instruments of the Congress. When things are going well, we treat you well. When things are not going well, we do not know you.

But I am not getting back to the Chairman's remark, optimistic about the administration's goal of a cap on GNMA backed securities, which I believe was $[illegible] billion.

Chairman GONZALEZ. I think we can overcome?

[illegible]

Mr. STANTON. Well, I do not think we are going to end up with your $68 billion either. Somewhere in between, I feel quite sure will be a realistic view about this.

That is just an observation.

You also referred to this forthcoming national conference. You had a conference a year ago, was it not, or was that before you got there?

Mr. MAXWELL. There was a conference in February of 1981 on the subject of mortgage finance, generally. But it did not focus on the role of the secondary market or the proper Federal mission.

Mr. STANTON. We are looking forward to that conference. But, in the meantime, as you well know, we are involved in legislation, especially from the Home Loan Bank Board, where there is emphasis on giving additional powers to the savings and loan industry.

We have had in town this week the representatives of the real estate industry in our country. They are primarily taking a stand against that for the sole reason that it would change the role of these institutions, which were the primary source of funds for housing.

I sympathize with their concern and I can see why they are worried. My question to you, though, is how do you see the secondary market changing as these institutions change? As to the handling of mortgages, we have experienced significant changes in the last quarter. Somebody said only 8 percent of all of the new mortgages issued in this country were by savings and loan institutions, compared to about 50 percent historically.

The secondary market has to change to reflect this. Do you agree with that statement or what are your thoughts?

Mr. MAXWELL. Well, I also do not want to preempt anything that the conference might include or that this subcommittee might be called upon to determine at a later date.

I think it is very hard to look into a crystal ball in the current crisis atmosphere and tell what the secondary market should, or will, look like.

Let me give you a couple of illustrations of that. First, in your colloquy with the chairman, Mr. Stanton, you discussed the level of GNMA activity. That is a very crucial matter in the context of the secondary market. If GNMA is going to be $68 billion, there will be a different kind of a secondary market than there will be if GNMA is going to be $38 billion. And we really do not know the answer to that question.

Second, I was at the same conference in Williamsburg that Mr. McKinney referred to. I heard the same people that you have been talking to this week. Also, the homebuilders were down there and I heard the leadership of the homebuilders speak in the strongest possible terms of their negative feelings about expanded powers for the savings and loan associations.

I do not know how that issue will be resolved. But I do know that there is certainly an indication that those groups would want the savings and loans to remain more dedicated to the housing business than maybe the savings and loans themselves would want.

So I think it is not easy to tell who is going to originate the mort- of the future. To the extent that those mortgages are adjust- rate mortgages, they may be originated for the portfolios of

the savings and loans themselves rather than for sale in the secondary market.

The third element is the question of the private entities that are becoming interested in the secondary market. The Merrill Lynches, the Sears, the other giant nonbank financial institutions that are developing in this country, with a kind of vertical integration of all real estate operations, will play a role in the future secondary market.

We would want them to participate in this conference to see to what extent they really intend to provide a market. You will be hearing from the president of the Mortgage Insurance Companies of America this morning. The mortgage insurance companies have also been active in providing a secondary market and actually in some cases, for example, Alabama, they have been able to funnel some State pension funds into mortgages.

So I think that a lot of these issues, Mr. Stanton, are open issues. And I think we probably need to get a better fix on where the housing industry is going to come out of this current emergency and where the savings and loans are going to come out, before we can really define the shape or the extent of the future secondary market. Indeed, the current atmosphere of crisis is not a good one in which to decide questions of this kind.

Mr. STANTON. Thank you very much.

Chairman GONZALEZ. Thank you.

Mr. Chairman?

Mr. ST GERMAIN. Good morning, welcome. I subscribe to what both my colleagues have said about your being a breath of fresh air.

Mr. MAXWELL. Thank you, sir.

Mr. ST GERMAIN. I would venture to say that your answer to Mr. Stanton's question was somewhat akin to the chicken-and-the-egg problem, which came first or which should come first?

Mr. MAXWELL. Yes, sir.

Mr. ST GERMAIN. We have had a great many people testifying, sitting at the table that you are not seated at and telling us that, well, if the thrifts reduce their amount of commitment to home mortgage financing, and they make strong reference to the secondary mortgage, that is still speculative because of the answer we just received from you and certainly you are in a position to know, and perhaps because as you say there is uncertainty as to what the future holds.

This uncertainty is probably the biggest problem we have on every front today, uncertainty of what the deficits are going to be, what interest rates are going to be, what taxes are going to be, who is going to provide the home mortgage financing. A lot of crucial questions.

Mr. MAXWELL. Yes, sir.

Mr. ST GERMAIN. I think that my colleagues and I all would be grateful to you if you would keep us informed as to your thoughts as they progress. Any new thoughts you might have. Because we have some very serious decisions to make.

Mr. MAXWELL. Yes, sir.

Mr. St Germain. In your discussion with Chairman Gonzalez, did I understand you to say that the higher the mortgage, the higher the yield?

Mr. Maxwell. That is generally the case, Mr. Chairman. The higher mortgage amounts generally command a higher yield.

Mr. St Germain. Where is the higher yield?

Mr. Maxwell. If the cost of the house is higher and therefore the mortgage is higher, generally the savings and loan institution or the mortgage banker, whoever, will charge a higher interest rate on that mortgage because it is larger.

Our ability to increase our ownership of high yielding mortgages would of course increase our income and let us buy more mortgages involving low- and moderate-income families.

Mr. St Germain. You stated also in answer to Mr. Gonzalez that there are certain areas of the country where I think 10 to 12 percent of the mortgages would be above the cap?

Mr. Maxwell. In California it would be more in the order of 20 percent.

Mr. St Germain. I must say to you that I am troubled with raising the cap and with the idea of, even if you leave the cap where it is, that the participation, just the amount of the participation has to come under the cap rather than that of the total mortgage. It seems to me that there are plenty of people out there who are seeking funds.

Remember, when we talk $107,000 cap on a mortgage, we are talking about a $135,000, $140,000 house. And a downpayment. That is not small potatoes. That is a rather substantial house.

I am going to have to consider that very, very carefully. We do not discount that we know you are trying to do as much business as possible to get as high a yield as possible, but on the other side of the coin, I think that the capacity now, there are not too many people buying homes in that price range.

California, of course, is different. God bless it, that is another country practically. So we will consider it carefully and have more conversations with you, either in open hearings or even in meetings, in the sunshine naturally.

But I have to say to you that I am a little troubled by it. Yet I want to try to understand as much as possible your reasoning and that of your handsome colleague who is behind you, the president.

Mr. Maxwell. Yes, sir.

Mr. St Germain. Thank you, Mr. Chairman.

Chairman Gonzalez. Thank you.

Mr. Bereuter.

Mr. Bereuter. Thank you, Mr. Chairman. I would invite our chairman to come visit my very modest looking $140,000 house here.

Chairman Gonzalez. In the District of Columbia?

Mr. Bereuter. In the District of Columbia.

Thank you very much for your testimony. I particularly appreciate the fact that we had in advance a chance to visit with your staff. That was very helpful.

I know that you indicate that FNMA has paid $950 million in ral taxes. I believe that the 1970's were rather good to the or-

ganization. And yet, is it not true you have had a substantial outflow of capital during recent years?

Mr. MAXWELL. Yes, that is absolutely true. The 1970's were the days when the short-term rates were below the long-term rates, so that we could borrow short term at a positive spread compared to the long-term mortgages that we bought.

Fortunately, the company did not pay out excessive dividends during that period. It did accumulate a large amount of capital. Our retained earnings—I am not proud of this—our retained earnings when I became chairman were over $800 million. At the moment they are a little over $500 million.

Mr. BEREUTER. That is not a reflection on you.

Mr. MAXWELL. I appreciate your saying so. So, yes, there is an erosion of capital, that is true.

Mr. BEREUTER. With respect to the $107,000 limit, I did note and I would reemphasize for the benefit of others who perhaps did not, that out of 26,000 participations which you had in the program last year, only 37 of those participation mortgages exceeded $107,000.

Mr. MAXWELL. That is correct, sir.

Mr. BEREUTER. What is likely to happen in the next year?

Mr. MAXWELL. Well, in the next year, as I said in my statement, out of respect to the subcommittee and its staff, we will not purchase participations where the mortgage amount is more than $107,000 until the Congress acts or declines to act on this matter.

Mr. BEREUTER. Because of the expressed concern of the Congress?

Mr. MAXWELL. Yes, sir.

Mr. BEREUTER. Mr. Chairman, I have no further questions.

Thank you for your testimony.

Chairman GONZALEZ. Thank you. Mr. Vento?

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Maxwell, we are pleased to have you with us today. The problems that FNMA has experienced are principally due to the lack of movement in terms of your portfolio as you have testified. You can deal with this in two ways.

One, we could have a reduction in interest rates, which clearly would then provide you with the opportunity in terms of rolling over these securities at closer to what the income is from your portfolio, or of course you could have growth.

And you know, given the fact that so much of this, as you indicate, $42 billion is under 10 percent, I do not know as I look to the future that I see, given the current mission of monetary policy, something that would, in fact, deal with that.

I know that even 12 percent would look far more attractive in terms of the types of interest rates we have had in the last year, in recent months especially. What magnitude of growth would you need in terms of your portfolio, for instance, to pay or offset the losses that you are experiencing?

What about the growth side of that question? I w[illegible] lil[illegible] you to just dwell a little bit more on that for the commit[illegible] mo[illegible]ng.

Mr. MAXWELL. Mr. Vento, in the last year, d[illegible] to our [illegible] ion of higher-yielding assets, our average yield on [illegible] of our [illegible] increased from 9.25 percent to 9.85 percent. We bo[illegible]t, [illegible] 1 billion of mortgages. That demonstrates the

can affect the negative spread by the acquisition of assets, by the increase of the average yield on our portfolio.

This is a long and slow process when you have $62 billion of assets to cope with. If interest rates were to stay at current levels indefinitely, we could not grow sufficiently over time to offset the drag of the portfolio.

Mr. VENTO. Concerning the secondary market or the second market provisions that are included in the chairman's bill, how important is that particular authority in light of the fact that you do have a lot of loans that are going down to pick up the old mortgages? Is it important that you get into that area of the marketplace?

You say here that you have a quarter of a million worth of paper written in that particular area. What do you anticipate would be the growth in that particular market? Obviously you see it as being a significant factor. Why do you not express thoughts on that?

Mr. MAXWELL. These second mortgages generally have higher yields and we have bought about $250 million. We have committed to buy about $300 million. So we will have some more coming in.

I think that this will have a positive effect on the portfolio yield and it is an important aspect of our self-help program. But I want to mention something that the chairman of the full committee said, because we have out there all of this seller paper and it does pose a tremendous threat, if it cannot be rolled over, when it all comes due.

Most of it is short-term balloon type paper. We are working hard to develop a program to be able to refinance some of this paper on a discount basis. If we can do this, we can remove the threat, if you will, from a lot of the market where refinancing otherwise will be a problem.

So I think that here, again, freeing FNMA from mortgage limits is a question not only of helping our own yields and our own economic situation, but also serving the housing market.

Mr. VENTO. I think that that is true. I think filling that part of the charter is very important. We also of course know that with interest approval, the opening of the market for portfolio of manufactured housing and leased land, under normal circumstances or conventional market we might look at those differently.

I think it indicates to me that FNMA is doing everything it can to help itself, and incidentally, is sort of coming in at the fore of what we consider the innovative type of housing programs that are necessary.

Mr. MAXWELL. Thank you.

Mr. VENTO. But how do you answer criticism leveled with respect to manufactured houses? How would you answer critics in that arena?

Mr. MAXWELL. Well, I am not sure that there is really more risk in the manufactured house now than there is in any other kind of house. FNMA has had a very good record on its underwriting. That is something that we really do well. We are the only secondary ket that I am aware of for these kinds of housing—for the ed land and the manufactured housing.

I appreciate your bringing that point forward. I believe that we can provide a good market for that type of housing on a sound underwriting basis.

Mr. VENTO. Well, I think for the record we might like to look at maybe some of the details of that, so I think if you could provide that it would be helpful. I want to raise just one other question. I do not want to delay this. The point being with the pension fund issue, the ERISA, the prudent man question, there has been some expression and great optimism expressed, almost everybody likes some flexiblity in this area. I think that obviously, you tend to endorse that and have been involved in Maryland here, which I know my colleague Steny Hoyer is probably going to remark about.

The question is: Does that offer the type of hope that there would be a rapid infusion of money in the housing funds as has been intimated by the administration, by many others and perhaps even myself? Is it really a situation where there are not purchasers for the securities that you are putting forth at competitive rates? Is that really the case?

I mean it is important to get to that market, but you have been working with other security markets on a regular basis. Is the optimism there with regard to the growth? In other words, is all of a sudden having cheaper money available for housing and so forth, realistic?

Can we expect any big upsurge in housing as those funds might be and the rules governing them might be more flexible with regard to housing? What is you view with regard to that?

Mr. MAXWELL. Well, I think that the opportunity in the public pension fund area, such as the Maryland transaction that we participated in, is a very great one. But it is important to remember that the Maryland Retirement Fund quite properly insisted on obtaining a market rate of return. They are getting 16 percent in that transaction.

Now, nevertheless, that is a lower rate than the mortgage market generally demands right now. If they had only bought the mortgages they would have asked for a 17 percent, or even an 18 percent, return instead of 16 percent. So the securities program does help with respect to the rates.

In the public pension fund area we are working with a lot of other States. I think we can provide some stimulus. It won't be the same kind of stimulus that would be provided by a drop in overall interest rate levels in the economy. With regard to the private pension funds, I think the Labor Department needs to move ahead with their changes in the ERISA regulations because our current forward commitment program for the mortgage-backed securities is somewhat hamstrung as to the private pension funds. They are reluctant to commit their resources in advance under the current ERISA regulations.

I would not overpromise on the whole program by saying that it is a panacea, because it is not. But when interest rate levels do come down, the FNMA conventional mortgage-backed security will be a tremendous conduit for bringing pension fund savings into the housing market. I am convinced of that.

Mr. VENTO. Well, I think it is important, you know, there are rules about barriers that are not reasonable in terms of [illegible]

markets. I happen to think that the secondary market has become much more important in terms of channeling money into the housing market than it ever has been in the past, largely because of the changing nature of financial institutions and the success that we are having in running such as the one you described today.

I think in the future you will play an important role in other secondary markets and devices. We are pleased to see you are working in this area, and we look forward to examining the changes you propose with regard to the legislative process.

Chairman GONZALEZ. Thank you, sir.

Mr. Hoyer?

Mr. HOYER. Thank you, Mr. Chairman. I want to join Mr. Bereuter; I thank you for taking the time to come by and discuss this with me personally. I told you then that I note that I came to the Congress, or I was sworn into the Congress, some days after you, but I was elected 2 days before you came, so we are somewhat contemporaries.

However, I am sure you came with a lot more expertise than I did, which I admit here but not out there, you understand.

Mr. MAXWELL. The only time I ran for Congress I lost.

Mr. HOYER. I have had that experience, too. Not running for Congress but for other offices.

Let me ask you about this procedure that FNMA participated in with Loyola and the State Retirement System. As I understand it, of course you and I discussed it briefly, but in your testimony—you just indicated in response to Mr. Vento's question that there is a 16 percent, which is somewhat below market. As I understand it, in 5 years there will be a determination and there will be a reconsideration of the rate. Is that correct?

Mr. MAXWELL. Yes; I said below market, which I really should clarify too. When you said it it came to my mind. The yield is below current yields in the mortgage market but it is actually a higher yielding investment for the pension fund than they could get if they bought corporate bonds or something of that kind. So the mortgage-backed security is a good investment for them.

Mr. HOYER. Let me ask you something, if you know, just as an interest to me, and perhaps to the committee and to the pension funds. What was the average return? The average return on the Maryland pension funds as you probably know has been quite low. Do you have any idea what it related to at this point in time?

Mr. MAXWELL. I can't answer that question.

Mr. HOYER. It is substantially lower than that because of conservative investments and somewhat legal limitations that the board itself is under?

Mr. MAXWELL. At the end of the 5-year period the pension fund has the right to sell the securities back to Loyola Federal. The pension fund wanted a 5-year investment, and the beauty of the FNMA security is that we could tailor it specifically to what they wanted. They can roll it over, if they wish to retain it, for each successive 5-year period at a rate then prevailing, based on FNMA's 5-year borrowing rate with a kicker on top of it.

The mortgages that underlie the securities will also be subject to ren[illegible]tiation of the rate at the end of this 5-year period. If Loyola [illegible] buys the securities back from the pension fund in accord-

ance with the contract, then FNMA will, in all likelihood, refinance the loans for Loyola Federal. That is how the 5-year situation would work.

Mr. HOYER. At the end of the 5 years, this comes about, the borrower I take it has agreed to be subject to whatever is then the prevailing rate?

Mr. MAXWELL. That is correct.

Mr. HOYER. OK. The 5-year option would be at the prevailing rate and would hold for an additional 5-year period?

Mr. MAXWELL. That is correct.

Mr. HOYER. What is the length of these mortgages?

Mr. MAXWELL. They are 30-year mortgages.

Mr. HOYER. There is no cap on them, so it could be at any rate then prevailing?

Mr. MAXWELL. Yes, sir.

Mr. HOYER. Let me go back to your question specifically about H.R. 5731. The chairman raised—the chairman of the full committee raised a question with respect to the $107,000 limit now and I disputed that, as to whether or not that is the full amount of the purchase price or the full amount of the indebtedness. The chairman raised a question, and you and I discussed this.

If in fact there is a higher yield, and if—in fact, you obviously ran a $190 million loss; is that correct?

Mr. Maxwell, isn't there an impetus from a good management standpoint, assuming—we don't expect you to go bankrupt—for you, if there is in fact a higher yield, you are running a loss, to participate in the higher mortgages; and therefore the risk that the chairman expresses and obviously his concern, and I am sure the chairman of the subcommittee's concern, about the unwillingness from a good business sense, from your standpoint it seems to me, to participate in the lower or moderate mortgage level market?

Mr. MAXWELL. It might seem so, but it is not in fact the case. The reason is that this part of the market is very limited. The key here is that we could not confine our operations to the higher priced end of the market, given FNMA's situation, the size of its portfolio and the size of its operations.

My position is that we ought to have the flexibility to buy mortgages at the upper end, and that actually that flexibility would buttress our support for the lower and moderate ends of the market. We intend, of course, as our charter requires us, to continue to buy those mortgages at a profitable yield. We do not intend to buy anything that won't yield us a property. The statute says we have to be self supporting and to do that we have to buy mortgages at market rates.

But our position is that the flexibility will enable us to better serve the market that we are mandated to serve under the Charter Act.

Mr. HOYER. How long has that cap been applicable?

Mr. MAXWELL. The cap has—the specific $107,000 or a cap? There has always been a cap.

Mr. HOYER. The specific $107,000?

Mr. MAXWELL. That just changed at the fi[illegible] t [illegible] course in Prince Georges County that cap w[illegible] e[illegible]

port for a higher percentage of the market than it would in a lot of other parts of the country.

Mr. HOYER. There is no differential?

Mr. MAXWELL. I don't understand that.

Mr. HOYER. There is no consideration of the market——

Mr. MAXWELL. I see. No. No, there is no variation. The statutory limit is a national figure.

Mr. HOYER. So in those areas where you have the higher market prices prevailing, they are less likely to be able to participate?

Mr. MAXWELL. Correct.

Mr. HOYER. As you know, I intend to support the thrust of what you want to do. If we can be confident, I think as the chairman says, he apparently is confident if you are running the shop, therefore I suppose I am confident. But I think that will be the nut on that particular question, whether we try to amend that provision of H.R. 5731.

If you have additional information on that, I think it would be helpful to me, and I am sure to the committee.

Mr. MAXWELL. Yes, sir.

Chairman GONZALEZ. Thank you, sir.

And thank you, Mr. Maxwell. We repeat, we are very grateful to you for your time and excellent testimony.

Mr. MAXWELL. Thank you, Mr. Chairman. I appreciate it.

Chairman GONZALEZ. We next have a panel, Mr. Fred Taylor, senior vice president, the Bankers Mortgage Corp., Columbia, S.C.; and Mr. William A. Whiteside, executive director of the Neighborhood Reinvestment Corp.; and Mr. Robert Waldo, who is the president of the Mortgage Insurance Companies of America.

Gentlemen, thank you for your cooperation and your generosity in presenting yourselves and offering your testimony. I might say for the record that it is with the warmest feelings that we welcome Mr. Taylor, in particular, because prior to joining the Bankers Mortgage Corp., I think in February of this year, Mr. Taylor has had a distinguished record of association with the Government National Mortgage Association, first as an executive assistant to the then President, John Dalton, who, incidentally, is now a business constituent of mine but an actual resident of the adjoining district in San Antonio. In the last 3 years, as its executive vice president, he has serviced.

I think sincerely that his talents and hard work have been invaluable to the operations of this committee, and certainly GNMA reflects it in the creation we attributed to him, the GNMA mortgage backed securities program. His high degree of professionalism and the assistance that, as I say and repeat, has always been provided us on the committee level during his tenure at GNMA.

I wanted to say this because those things did not go unnoticed. They were not unappreciated, and I think the record should show it. So we are very pleased to have you here today, Mr. Taylor. We will lead off with you and recognize you at this point.

STATEMENT OF FRED TAYLOR, SENIOR VICE PRESIDENT, BANKERS MORTGAGE CORP., COLUMBIA, S.C.

Mr. TAYLOR. Thank you very much, Mr. Chairman and members of the subcommittee. My name is Fred Taylor. As you know, I am senior vice president of Bankers Mortgage Corporation of Columbia, S.C. I deeply appreciate this opportunity to appear before you today to discuss the administration's fiscal year 1983 budget proposal.

As you can understand, I will focus my remarks on the programs of the Government National Mortgage Association. The administration's fiscal year 1983 budget proposal calls for a 40-percent cut in GNMA's mortgage-backed securities commitment authority below the congressionally approved fiscal year 1982 level of $68.25 billion. The administration has proposed that the fiscal year 1982 commitment level be reduced to $48 billion, and it has announced plans to implement a new fee structure in fiscal year 1983 to assist in the allocation of the reduced commitment volume. The fiscal year 1983 budget proposal also calls for the termination of the GNMA tandem programs.

Given the condition of the housing and mortgage markets, these proposals could adversely affect the already beleaguered housing sector and, therefore, should be rejected. Furthermore, in terms of the serious budget deficit facing the administration and the Congress, the proposal to cut the level of GNMA commitment authority is, in fact, counterproductive, since it could result in lower negative outlays being generated by this program.

Currently, our Nation's housing industry is in its deepest recession since World War II. Private single-family housing starts are at one of the lowest levels on record. Unemployment in the construction industry has reached over 18 percent and is likely to go higher. Builders are being forced out of business in record numbers and concern is being expressed in several parts of the country that the builder infrastructure is being eroded.

The problem, as we are all well aware, is the lack of adequate mortgage credit at an affordable price. GNMA's two basic programs were specifically designed to address this problem. The tandem program offers interest rate relief for selected types of multifamily production, while the GNMA mortgage-backed securities program attracts new sources of credit to the residential mortgage market, and, by doing so, lowers the overall cost of borrowing. Studies now suggest that the market efficiencies arising from this program reduce the cost of mortgage credit by as much as ½ of 1 percent to the borrower.

In view of the need for and success of these programs, why cut them back so drastically in fiscal year 1983—the very time that the housing sector will be counted on to help lead our Nation toward a strong economic recovery?

From both an economic as well as budgetary standpoint, the proposal to reduce GNMA's mortgage-backed security commitment level is difficult to justify. The proposal to eliminate tandem in fiscal year 1983 raises serious equity considerations.

From a philosophical standpoint, the idea of shifting certain Federal programs and responsibilities to the private [illegible]

possible has considerable merit. However, there is no convincing evidence that the private sector is capable of filling the void which would be created by the proposed reductions in GNMA activity.

Today, the two principal alternatives to the GNMA programs are offered by its sister agencies—the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA). These agencies, however, are facing their own financing problems which could severely limit their ability to expand their secondary market roles sufficiently to offset the proposed cutbacks at GNMA. The thrift industry certainly does not appear to be in a position to significantly expand its mortgage purchase or lending activities, nor does the private mortgage-backed securities market appear to be growing as rapidly as had been anticipated. The dollar volume of publicly offered, truly private, mortgage backed securities, net of the so-called tax-exempt mortgage revenue securities, has shown in fact very little growth.

As I mentioned earlier, the special assistance function or the so-called tandem programs will be eliminated under the administration's budget proposal. No new commitments are planned for fiscal year 1983. Last year the administration requested $3.6 billion in commitment authority to permanently finance projects that were in various stages of FHA insurance processing. However, the Congress approved only $1.973 billion of the administration's request and reopened the FHA processing pipeline to allow additional projects to become eligible to compete for the scarce, below market rate tandem commitments.

A total cutoff of tandem funds in fiscal year 1983 raises two important issues. First, what will be the source of permanent funding for tandem-eligible multifamily projects? Second, is the issue of equity. The administration based its fiscal year 1982 tandem request, in part, on equity considerations. This issue is just as valid this year and may be somewhat stronger since Congress mandated the reopening of the processing pipeline.

In testimony last year, the administration defended the eventual elimination of tandem based partly on its projections that by fiscal year 1983 interest rates would have dropped sufficiently to allow the market to provide adequate financing. Interest rate forecasts have been substantially revised over the past 12 months and there is no certainty that there will be a viable alternative to tandem in fiscal year 1983. At a minimum, the argument can be made that this program's phaseout should be postponed for a year in order to provide more time for interest rates to drop and to afford those developers that were given the opportunity to apply but missed their tandem funding in fiscal year 1982 the same treatment afforded those that were unsuccessful in obtaining necessary funding in fiscal year 1981.

While the tandem programs do involve a direct Federal subsidy and thus may add to the Federal deficit, the GNMA mortgage backed securities program does not.

During the 12 years this program has been in operation, it has helped to provide home financing for nearly 4 million American families. It has become the lifeblood of the mortgage banking in-·y and it has helped to stimulate jobs in the construction, ap-ance, textile, furniture, and related industries.

This program operates with a minimum of red tape and is actuarially sound. In fact, its reserves increased by more than $90 million in fiscal year 1981 alone. This program, which has not cost the American taxpayer $1 in tax revenue is, in my opinion, the most successful housing program ever authorized by Congress.

Now, one justification that has been advanced for the proposed reduction in commitment levels is the introduction of GNMA-like mortgage backed securities programs by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. Although we all hope that the FHLMC's and FNMA's programs will be successful in expanding the volume of credit available for conventional as well as Government-underwritten mortgages, these programs do not appear to be able to substitute for GNMA in the near future. Up to this time, there has not been one issue of mortgage backed securities placed by these agencies which were backed by newly originated loans.

In justifying the proposed reduction in GNMA commitment authority, much, too, has been made of the fact that issuers have not requested $68 billion commitment authority in past years. While it is true that GNMA has never used $68 billion in commitment authority in any year, part of the explanation recently lies in the state of the market and the belief on the part of mortgage originators and packagers that sufficient authority would always be available.

My guess is that if the Congress approves a level of commitment authority substantially below what is perceived by the market as needed, issuers will attempt to hoard these 12-month commitments by buying up as many as they can afford and qualify for at the end of this fiscal year. Those that are unable to hoard sufficient commitments are likely to request as many as possible at the beginning of fiscal year 1983, as a hedge against rising production and further cuts by the administration. This could conceivably exhaust the $38.4 billion level early in the fiscal year.

If GNMA were to exhaust its commitment authority, even temporarily severe disruptions could result. Homebuilders, lenders, and realtors rely on a steady flow of credit and the ability to plan ahead. The sensitive futures and options markets would also be disrupted by an interruption in the supply of new securities.

To prevent this occurrence, GNMA might be forced to implement a complicated allocation system. This could require a larger staff and involve more red tape—something that I think none of us wants to see.

As the figures on the attached table indicate, the admir
is proposing that the market immediately adopt to a sharp
in the ratio of GNMA commitments obtained to securi
Over the past 4 fiscal years (1978–81), this ratio has
2.1 to 1 in fiscal year 1978 to 2.75 to 1 in fiscal year 198υ.

Historically, this ratio has averaged better than 2 to 1. M
tors contribute to this relationship but most importantly
reflects the need of mortgage bankers, such as Bankers
Corp., to hedge their loan purchase and production activity.
straining the ability of firms to cover their mor
proposal could reduce the level of activity in t

The two main reasons why commitments often exceed guarantees are overestimation of production and changes in secondary market prices. If Bankers Mortgage Corp., for example, commits to purchase up to $50 million in FHA/VA loans from an originator, we will immediately obtain a GNMA commitment to cover our standby exposure. However, the seller may be able to deliver only $25 million because of its inability to originate loans as rapidly as anticipated.

Even these $25 million would never be used by us to back a GNMA security if the prices offered by FNMA or some other secondary market purchaser rise above the GNMA security price. Thus, we could have obtained a $50 million GNMA commitment for a legitimate purpose, that of hedging, yet never use it. However, had sufficient commitment authority not been available, this transaction might never have taken place.

Finally, the administration has proposed a new fee structure for the GNMA program. Certainly, we can appreciate the need for a fee to cover the cost of delivering a service. The new $250 fee for first-time issuers in this regard appears to be justified. However, I do not believe the administration can justify from a cost-to-Government standpoint the escalating fee for commitments. It is my understanding that the present fee of $500 per commitment is sufficient to offset the processing costs incurred by GNMA. I doubt that the new fee structure will work as an allocator of GNMA's commitment authority because issuers will pay whatever is necessary to obtain the commitments they need and then pass the higher costs on to the homebuying public.

As our economy moves toward eventual recovery, the housing industry will be called on to play an important role. Without the necessary tools at its disposal, such as sufficient GNMA commitment authority, the anticipated expansion in housing will be delayed. Therefore, I urge this subcommittee to postpone the termination of the tandem program for 1 year and to approve a higher level of mortgage backed security commitment authority than has been proposed by the administration.

This concludes my prepared remarks. I will be happy to answer any questions you may have regarding my statement.

[Mr. Taylor's prepared statement follows:]

STATEMENT OF FRED TAYLOR
SENIOR VICE PRESIDENT, BANKERS MORTGAGE CORPORATION

Mr. Chairman and Members of the Subcommittee:

My name is Fred Taylor. I am a Senior Vice President of Bankers Mortgage Corporation of Columbia, South Carolina. I appreciate this opportunity to appear before you today to discuss the Administration's FY1983 budget proposal. I will focus my remarks on the programs of the Government National Mortgage Association (GNMA).

The Administration's FY1983 budget proposal calls for a [illegible] percent cut in GNMA's mortgage-backed securities commitment authority below the Congressionally-approved FY1982 level of $[illegible] billion. The Administration has proposed that the FY1982 commitment level be reduced to $[illegible] billion and it has announced plans to implement a new fee structure in FY1983 to assist in the allocation of the reduced commitment volume. The FY1983 budget proposal also calls for the termination of the GNMA Tandem programs.

Given the condition of the housing and mortgage markets, these proposals would adversely affect the already beleaguered housing sector and, therefore, should be rejected. Furthermore, in terms of the federal budget deficit facing the Administration and the Congress, the proposal to cut the level of GNMA commitment authority is, in fact, counter-productive, since it would result in lower receipts to the Treasury being generated by this program.

CURRENTLY, OUR NATION'S HOUSING INDUSTRY IS IN ITS DEEPEST RECESSION SINCE WORLD WAR II. PRIVATE SINGLE-FAMILY HOUSING STARTS ARE AT ONE OF THE LOWEST LEVELS ON RECORD. UNEMPLOYMENT IN THE CONSTRUCTION INDUSTRY HAS REACHED OVER 18 PERCENT AND IS LIKELY TO GO HIGHER. BUILDERS ARE BEING FORCED OUT OF BUSINESS IN RECORD NUMBERS AND CONCERN IS BEING EXPRESSED IN SEVERAL PARTS OF THE COUNTRY THAT THE BUILDER INFRASTRUCTURE IS BEING ERODED. THE PROBLEM AS WE ARE ALL AWARE IS THE LACK OF ADEQUATE MORTGAGE CREDIT AT AN AFFORDABLE PRICE. GNMA'S TWO BASIC PROGRAMS WERE SPECIFICALLY DESIGNED TO ADDRESS THIS PROBLEM. THE TANDEM PROGRAM OFFERS INTEREST RATE RELIEF FOR SELECTED TYPES OF MULTIFAMILY PRODUCTION, WHILE THE GNMA MORTGAGE-BACKED SECURITIES PROGRAM ATTRACTS NEW SOURCES OF CREDIT TO THE RESIDENTIAL MORTGAGE MARKET, AND, BY DOING SO, LOWERS THE OVERALL COST OF BORROWING. STUDIES NOW SUGGEST THAT THE MARKET EFFICIENCIES ARISING FROM THIS PROGRAM REDUCE THE COST OF MORTGAGE CREDIT BY AS MUCH AS ONE-HALF OF ONE PERCENT TO THE BORROWER.

IN VIEW OF THE NEED FOR AND SUCCESS OF THESE PROGRAMS, WHY CUT THEM BACK SO DRASTICALLY IN FY1983 --THE VERY TIME THAT THE HOUSING SECTOR WILL BE COUNTED ON TO HELP LEAD OUR NATION TOWARD A STRONG ECONOMIC RECOVERY?

FROM BOTH AN ECONOMIC AS WELL AS BUDGETARY STANDPOINT, THE PROPOSAL TO REDUCE GNMA'S MORTGAGE-BACKED SECURITY COMMITMENT LEVEL IS DIFFICULT TO JUSTIFY. THE PROPOSAL TO ELIMINATE TANDEM IN FY1983 RAISES SERIOUS EQUITY CONSIDERATIONS.

FROM A PHILOSOPHICAL STANDPOINT, THE IDEA OF SHIFTING CERTAIN FEDERAL PROGRAMS AND RESPONSIBILITIES TO THE PRIVATE SECTOR WHENEVER POSSIBLE HAS CONSIDERABLE MERIT. HOWEVER, THERE IS NO CONVINCING EVIDENCE THAT THE PRIVATE SECTOR IS CAPABLE OF FILLING THE VOID WHICH WOULD BE CREATED BY THE PROPOSED REDUCTIONS IN GNMA ACTIVITY.

TODAY, THE PRINCIPAL ALTERNATIVES TO THE GNMA PROGRAMS ARE [illegible] BY ITS SISTER AGENCIES — THE FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC), AND THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA). THESE AGENCIES, HOWEVER, ARE FACING THEIR OWN FINANCING PROBLEMS WHICH COULD SERIOUSLY LIMIT THEIR ABILITY TO EXPAND THEIR SECONDARY MARKET ROLES SIGNIFICANTLY TO OFFSET THE PROPOSED CUTBACKS OF GNMA. THE PRIVATE SECONDARY MARKET DOES NOT APPEAR TO BE IN A POSITION TO SIGNIFICANTLY EXPAND, [illegible]

A[illegible]

A TOTAL CUT-OFF OF TANDEM FUNDS IN FY1983 RAISES TWO IMPORTANT ISSUES. FIRST, WHAT WILL BE THE SOURCE OF PERMANENT FUNDING FOR TANDEM-ELIGIBLE MULTIFAMILY PROJECTS? SECOND, IS THE ISSUE OF EQUITY. THE ADMINISTRATION BASED ITS FY1982 TANDEM REQUEST, INPART, ON EQUITY CONSIDERATIONS. THIS ISSUE IS JUST AS VALID THIS YEAR AND MAY BE SOMEWHAT STRONGER SINCE CONGRESS MANDATED THE REOPENING OF THE PROCESSING PIPELINE. IN TESTIMONY LAST YEAR, THE ADMINISTRATION DEFENDED THE EVENTUAL ELIMINATION OF TANDEM BASED PARTLY ON ITS PROJECTIONS THAT BY FY1983 INTEREST RATES WOULD HAVE DROPPED SUFFICIENTLY TO ALLOW THE MARKET TO PROVIDE ADEQUATE FINANCING. INTEREST RATE FORECASTS HAVE BEEN SUBSTANTIALLY REVISED OVER THE PAST TWELVE MONTHS AND THERE IS NO CERTAINTY THAT THERE WILL BE A VIABLE ALTERNATIVE TO TANDEM IN FY1983. AT A MINIMUM, THE ARGUMENT CAN BE MADE THAT THIS PROGRAM'S PHASE OUT SHOULD BE POSTPONED FOR A YEAR INORDER TO PROVIDE MORE TIME FOR INTEREST RATES TO DROP AND TO AFFORD THOSE DEVELOPERS THAT WERE GIVEN THE OPPORTUNITY TO APPLY BUT MISSED THEIR TANDEM FUNDING IN FY1982 THE SAME TREATMENT AFFORDED THOSE THAT WERE UNSUCCESSFUL IN OBTAINING NECESSARY FUNDING IN FY1981.

WHILE THE TANDEM PROGRAMS DO INVOLVE A DIRECT FEDERAL SUBSIDY AND THUS MAY ADD TO THE FEDERAL DEFICIT, THE GNMA MORTGAGE-BACKED SECURITIES PROGRAM DOES NOT.

DURING THE TWELVE YEARS THIS PROGRAM HAS BEEN IN OPERATION, IT HAS HELPED TO PROVIDE HOME FINANCING FOR NEARLY 4 MILLION AMERICAN FAMILIES. IT HAS BECOME THE "LIFE BLOOD" OF THE MORTGAGE BANKING INDUSTRY AND IT HAS HELPED TO STIMULATE JOBS IN THE CONSTRUCTION, APPLIANCE, TEXTILE, FURNITURE AND RELATED INDUSTRIES.

The program operates with a minimum of "red-tape" and is actuarially sound. In fact, its reserves increased by more than $[illegible] million in [illegible] alone. This program, which has not cost the American taxpayer one dollar in its history, is, in my opinion, the most successful housing program ever authorized by Congress.

One justification that has been advanced for the proposed reduction in commitment levels is the introduction of GNMA-like mortgage-backed securities programs by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association. Although we all hope that the FHLMC and FNMA programs will be successful in broadening the volume of credit available for conventional as well as government-underwritten mortgages, these programs do not appear to be able to substitute for GNMA in the near future. As of this time, there has not been one issue of mortgage-backed securities placed by these agencies which were backed by newly originated loans.

In justifying the proposed reduction in GNMA commitment authority, much has been made of the fact that issuers have not requested $[illegible] billion in past years. While it is true that GNMA has never used $[illegible] billion in commitment authority in any year, part of the explanation certainly lies in the state of the market and the belief on the part of mortgage originators and packagers that sufficient authority would always be available. My guess is that if the Congress approves a level of commitment authority substantially below what is perceived by the market as needed, issuers will attempt to hoard these twelve month commitments by buying up as many as they can afford and qualify for at the end of this fiscal year.

THOSE THAT ARE UNABLE TO HOARD SUFFICIENT COMMITMENTS ARE LIKELY TO REQUEST AS MANY AS POSSIBLE AT THE BEGINNING OF FY1983, AS A HEDGE AGAINST RISING PRODUCTION AND FURTHER CUTS BY THE ADMINISTRATION. THIS COULD CONCEIVABLY EXHAUST THE $38.4 BILLION LEVEL EARLY IN THE FISCAL YEAR. IF GNMA WERE TO EXHAUST ITS COMMITMENT AUTHORITY, EVEN TEMPORARILY, SEVERE DISRUPTIONS COULD RESULT. HOMEBUILDERS, LENDERS AND REALTORS RELY ON A STEADY FLOW OF CREDIT AND THE ABILITY TO PLAN AHEAD. THE SENSITIVE FUTURES AND OPTIONS MARKETS WOULD ALSO BE DISRUPTED BY AN INTERRUPTION IN THE SUPPLY OF NEW SECURITIES.

TO PREVENT THIS OCCURRENCE, GNMA MIGHT BE FORCED TO IMPLEMENT A COMPLICATED ALLOCATION SYSTEM. THIS COULD REQUIRE A LARGER STAFF AND INVOLVE MORE "RED-TAPE" --SOMETHING THAT I THINK NONE OF US WANTS TO SEE.

AS FIGURES ON THE ATTACHED TABLE INDICATE, THE ADMINISTRATION IS PROPOSING THAT THE MARKET IMMEDIATELY ADOPT TO A SHARP CHANGE IN THE RATIO OF GNMA COMMITMENTS OBTAINED TO SECURITIES ISSUED. OVER THE PAST FOUR FISCAL YEARS (1978-81), THIS RATIO HAS RANGED FROM 2.1 TO 1 IN FY1978 TO 2.75 TO 1 IN FY1980.

HISTORICALLY, THIS RATIO HAS AVERAGED BETTER THAN 2 TO 1. MANY FACTORS CONTRIBUTE TO THIS RELATIONSHIP BUT MOST IMPORTANTLY THIS RATIO REFLECTS THE NEED OF MORTGAGE BANKERS, SUCH AS BANKERS MORTGAGE CORPORATION, TO HEDGE THEIR LOAN PURCHASE AND PRODUCTION ACTIVITY. BY RESTRAINING THE ABILITY OF FIRMS TO COVER THEIR MORTGAGE POSITIONS, THIS PROPOSAL COULD REDUCE THE LEVEL OF ACTIVITY IN THE SECONDARY MARKET.

GNMA MORTGAGE-BACKED SECURITY
COMMITMENT/GUARANTEE ACTIVITY
(DOLLARS IN BILLIONS)

FISCAL YEAR	COMMITMENTS	GUARANTEES	RATIO C/G
	ACTUAL		
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
	[illegible]*		
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]

*[illegible]

[illegible]

THE TWO MAIN REASONS WHY COMMITMENTS OFTEN EXCEED GUARANTEES ARE OVER-ESTIMATION OF PRODUCTION AND CHANGES IN SECONDARY MARKET PRICES. IF BANKERS MORTGAGE CORPORATION, FOR EXAMPLE, COMMITS TO PURCHASE UP TO $50 MILLION IN FHA/VA LOANS FROM AN ORIGINATOR, WE WILL IMMEDIATELY OBTAIN A GNMA COMMITMENT TO COVER OUR STANDBY EXPOSURE. HOWEVER, THE SELLER MAY BE ABLE TO DELIVER ONLY $25 MILLION BECAUSE OF ITS INABILITY TO ORIGINATE LOANS AS RAPIDLY AS ANTICIPATED. EVEN THESE $25 MILLION WOULD NEVER BE USED BY US TO BACK A GNMA SECURITY IF THE PRICES OFFERED BY FNMA OR SOME OTHER SECONDARY MARKET PURCHASER RISE ABOVE THE GNMA SECURITY PRICE. THUS, WE COULD HAVE OBTAINED A $50 MILLION GNMA COMMITMENT FOR A LEGITIMATE PURPOSE (HEDGING), YET NEVER USE IT. HOWEVER, HAD SUFFICIENT COMMITMENT AUTHORITY NOT BEEN AVAILABLE, THIS TRANSACTION MIGHT NEVER HAVE TAKEN PLACE.

FINALLY, THE ADMINISTRATION HAS PROPOSED A NEW FEE STRUCTURE FOR THE GNMA PROGRAM. CERTAINLY, WE CAN APPRECIATE THE NEED FOR A FEE TO COVER THE COST OF DELIVERING A SERVICE. THE NEW $250 FEE FOR FIRST-TIME ISSUERS IN THIS REGARD APPEARS TO BE JUSTIFIED. HOWEVER, I DO NOT BELIEVE THE ADMINISTRATION CAN JUSTIFY FROM A COST-TO-GOVERNMENT STANDPOINT THE ESCALATING FEE FOR COMMITMENTS. IT IS MY UNDERSTANDING THAT THE PRESENT FEE OF $500 PER COMMITMENT IS SUFFICIENT TO OFFSET THE PROCESSING COSTS INCURRED BY GNMA. I DOUBT THAT THE NEW FEE STRUCTURE WILL WORK AS AN ALLOCATOR OF GNMA'S COMMITMENT AUTHORITY BECAUSE ISSUERS WILL PAY WHATEVER IS NECESSARY TO OBTAIN THE COMMITMENTS THEY NEED AND THEN PASS THE HIGHER COSTS ON TO THE HOMEBUYING PUBLIC.

AS OUR ECONOMY MOVES TOWARD EVENTUAL RECOVERY, THE HOUSING INDUSTRY WILL BE CALLED ON TO PLAY AN IMPORTANT ROLE. WITHOUT THE NECESSARY TOOLS AT ITS DISPOSAL, SUCH AS SUFFICIENT GNMA COMMITMENT AUTHORITY, THE ANTICIPATED EXPANSION IN HOUSING WILL BE DELAYED. THEREFORE, I URGE THE SUBCOMMITTEE TO POSTPONE THE TERMINATION OF THE TANDEM PROGRAM FOR ONE YEAR AND TO APPROVE A HIGHER LEVEL OF MORTGAGE BACKED SECURITY COMMITMENT AUTHORITY THAN HAS BEEN PROPOSED BY THE ADMINISTRATION.

[illegible]

Chairman [illegible]. Thank you very much, Mr. [illegible], for an excellent presentation. We are going to go ahead and [illegible] Mr. [illegible] [illegible] presentation.

STATEMENT OF ROBERT [illegible], PRESIDENT, [illegible] INSURANCE COMPANIES OF [illegible]

Mr. [illegible]. Thank you [illegible]

[illegible]

in their protfolios as portfolio investments. Without elaborating, we know what this system has done to the thrift institutions. We can also predict that prospectively, while thrifts will begin to be deeply involved in housing, their involvement will be in the origination and servicing of loans and not as a portfolio investor.

The long-term capital, formerly provided by thrifts, must in the future come from the general capital markets. In the past, the only access that mortgages have had to the general capital markets has been through GNMA certificates. Until the past 2 years, there has been no burning need for a counterpart vehicle to market conventional loans.

Obviously, that burning need now exists. It is being met in part by the conventional mortgage bank security programs that were recently initiated by FNMA which our industry not only heartily applauded but as an industry we have heartily endorsed.

Incidentally, Mr. Chairman, as someone not related to FNMA, but having dealt with FNMA over a period of years, I would like to simply go on record as saying that I think Mr. Maxwell and his new team have done a tremendous job of not only doing what FNMA is supposed to be doing but of innovating and creating new programs that are designed to not only help FNMA get over its own problems but also help housing. It has really been a pleasure for us as suppliers to FNMA to work with them.

In addition to the FNMA program, of course, there have been other proposals. The Federal Home Loan Mortgage Corporation seeks legislation to restructure itself to get into a similar program. There have been a number of private companies such as ourselves, others in our own industry, and a number of investment bankers that have arranged for private placement of mortgage backed securities with pension funds and other institutional investors. The successes of these issues demonstrate that conventional loans are viewed as acceptable investments by the capital markets, and that conventional mortgage backed securities will flourish if they are only given a structure which will simplify registration and sale under Federal and state securities laws, which will clarify the authority of pension funds and other institutional investors to buy and hold these securities and will eliminate a number of troublesome and vexing income tax questions.

This has not existed in the past and it doesn't exist now because there has been no need for it in the past. In fact, the demonstrated acceptability of securities by conventional loans leads to the conclusion that the private sector's ability to contribute to the resuscitation of housing should be emphasized and that there is really not any need to reemphasize government involvement in the financing and marketing of unsubsidized home loans.

In fact, such Government involvement may now be reduced. We believe that Government involvement should be reduced because, as I said earlier, Government credit demands both direct and indirect, do adversely impact the costs of money for all borrowers.

Government involvement may be reduced without adverse consequences to housing. As we point out in our full statement, the private sector has ample capacity to pick up the unsubsidized business of the FHA so that it can be redirected to its original purpose of

assisting those borrowers who cannot be economically served by the private sector.

Also as pointed out in our full statement, any borrower who qualifies for an FHA unsubsidized loan would qualify for a conventional privately insured financed loan. Given equal access to the capital markets, that is very important, given equal access to the capital markets, conventional loans which are represented by conventional mortgage backed securities are as acceptable as mortgage related securities as GNMA certificates.

Therefore, we urge that action be taken to facilitate the development of a structure and market for conventional mortgage backed securities and we support the administration's recommended limits for fiscal year 1983 on the financing authority of the FHA and GNMA. These limits as proposed are $35 billion for the FHA and $38.4 billion for GNMA.

We note that both amounts are substantially in excess of the amount of business that either agency is likely to conduct. Therefore, the imposition of these limits, in our opinion, will not create any further hardship on or disruption in the housing market. At the same time, and equally important as HUD Secretary Pierce pointed out in his testimony yesterday before the Senate Housing Subcommittee, these realistic and practical limits will send to the market a signal that there is ample room for private alternatives to grow and prosper.

With respect to specific legislation, I think rather than comment with respect to specific bills, I would just like to make some general observations.

First of all, we are very encouraged by the fact that there has been a number of housing stimulant bills proposed both in this subcommittee and in the Senate subcommittee. I am sure that in the wisdom of the House and the Senate, an acceptable bill will come forth. I would like to make the observation, first of all, that the private sector's involvement should not be precluded.

For example, Mr. Chairman, in H.R. 5731, I think a substantial emphasis is put on revitalizing section 235 which would involve the FHA substantially. Since section 235 was first used back in the midsixties, I believe that the private sector has grown substantially and the private mortgage finance companies not have only the capability of financing those loans but could do an excellent job of it.

Further, I would also suggest that perhaps some of the limits that have been imposed on FNMA and FHLMC purchasing authority might not be appropriate. I believe the market requires all of the flexibility that it can possibly get in the ability of anyone who can afford to purchase loans to do just that job.

That concludes my remarks and I am available for questions. Thank you very much, again, for this opportunity.

Mr. GONZALEZ. That you, Mr. Waldo.

Mr. Whiteside.

[Mr. Waldo's prepared statement, on behalf of the Mortgage Insurance Companies of America, follows:]

STATEMENT OF ROBERT L. WALDO, PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA* BEFORE THE HOUSE HOUSING SUBCOMMITTEE IN REGARD TO 1982 HOUSING LEGISLATION.

March 31, 1982

Mr. Chairman and Members of the Subcommittee:

My name is Robert L. Waldo and I appear before you as President of the Mortgage Insurance Companies of America, a trade association of private mortgage insurance companies. Of the fifteen companies presently writing mortgage insurance thirteen are members of this Association. Our members represent a 98% share of the private mortgage insurance market.

I am also President and Chief Operating Officer of Verex Assurance, Inc. with home offices in Madison, Wisconsin. My company writes mortgage insurance in 50 states, Puerto Rico, and the District of Columbia.

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* The Mortgage Insurance Companies of America is a trade association consisting of thirteen domestic private mortgage insurance companies whose insurance-in-force on December 31, 1981 was $114.3 billion. The national officers of the Association are Robert L. Waldo (President of Verex Assurance, Inc.), Madison, Wisconsin, President; Leon T. Kendall, (President of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, Vice President; William A. Simpson, (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Secretary; Claude E. Pope, (President of American Mortgage Insurance Company), Raleigh, North Carolina, Treasurer; and John C. Williamson, Washington, D.C., Executive Vice President.

The industry I represent is inextricably linked to housing. Since mortgage insurance companies are legally restricted in most jurisdictions to a single line of business — insuring lenders against losses on residential mortgages. From our perspective we know firsthand that the housing market has a major impact on the nation's economic well-being, and that housing consumes about [illegible] of all long-term capital credit raised annually.

We also know that profound changes are occurring in the way home purchases are financed. All of our members are subsidiaries of, or have close ties to, major corporations through which additional financial services are provided to lenders. The principal additional service we provide is secondary marketing, or finding investors for loans originated by the insurer's lender customers and we have seen the need for this collateral service to expand several-fold within the last five years.

From the mid 1930's through the 1970's, 70% to 80% of the funds to finance housing were provided by portfolio lenders. Federal credit guarantees played a role in raising the 20% to 30% of housing capital not provided by portfolio lenders. First in the FHA loans originated by non-portfolio lenders and sold to various investors, and later through the secondary outlet provided by the Federal National Mortgage Association (FNMA), and later still through Government National Mortgage Association

(GNMA) certificates distributed directly into the general capital markets. It is now clear that the housing finance institutions are being reforged in the current economic environment, as thrift institutions have found that the risk of wide fluctuations in interest rates precludes them from supporting an asset base made up of long-term debt with liabilities made up of short-term, volatile deposits. Hence, in the future the capital markets must provide the bulk of the funds previously available to housing through portfolio lenders, as well as that already being provided through the non-portfolio lenders.

In the most recent 50 years of development of securities regulation and the capital markets generally, there has been no need to provide a means of publicly marketing conventional loans. The need for that capability now exists, and creating the capability will require a comprehensive approach.

Whole loans are suitable investments for portfolio lenders, but are unwieldy as investments for other institutions which represent major sources of future mortgage funding. Under current securities registration laws and regulations, almost insurmountable problems stand in the way of creating a "security" backed by conventional loans. The means must be found for allowing conventional loans to have free and adequate access to the capital markets without burdensome and unnecessary registration requirements.

Historical experience demonstrates that conventional mortgages, standing alone or in the form of a mortgage backed security, are investments of the quality and standards required by most fiduciary investors. However, questions persist under various state laws and other regulations which still inhibit many potential investors from buying conventional loans or conventional mortgage backed securities. Legislation is needed to circumvent or supersede restrictive laws and regulations that retard these institutions' investments in housing.

Given a solution to these matters, a large institution could originate mortgages and thereafter create and sell conventional mortgage-backed securities. The small, localized lender, however, would have access to the capital market only through an intermediary willing to purchase loans from [illegible] lenders and, in turn, [illegible] would issue. Under current [illegible] uncertainty as to whether the [illegible] the underlying [illegible] small, localized [illegible] the mortgage [illegible] capital markets.

[illegible]
ages of [illegible]
being [illegible]
has recently [illegible]

conventional mortgage-backed securities with certain FNMA guarantees; and because of FNMA's history and structure its securities will find acceptance in the marketplace and many of the inhibitions listed earlier will be avoided. Similarly, the Federal Home Loan Mortgage Corporation (FHLMC) has proposed amendments to its charter that will allow it to operate programs similar to those of FNMA, which likewise will have the benefit of market accessability and investor familiarity. However, much more needs to be done, and it is our hope that the private sectors concerned can agree on comprehensive legislative proposals that would provide a regulatory structure allowing all conventional housing finance free access to the capital markets.

The problems just discussed pertain to the adequacy of the supply of capital for housing. A problem of equal proportion is the ability of borrowers to afford the cost of home financing in today's economy. We suggest that the continuation -- and particularly an expansion -- of federal involvement in housing credit guarantees will serve to both disrupt the flow of capital to housing through conventional sources, and to increase the cost of capital to all borrowers. Accordingly, we have supported the Administration's proposals to place limits, in FY1983, on the commitment authority of both the FHA and GNMA. We believe these limitations will have no adverse effect on the availability of housing or mortgage financing, that no segment of the public will be adversely affected, and that, in fact, such limitations, as one of the many steps needed to curb the use of direct federal

credit and federal credit guarantees, [illegible] and balance to the economy.

In addressing these [illegible] must naturally be concerned with the private [illegible] industry, its structure, its financial [illegible] serves.

The risk characteristics of [illegible] under the FHA [illegible] program and loans insured by [illegible] similar. [illegible] insure the risk portion; that is, [illegible] mortgage and [illegible] of a 95% mortgage. [illegible] proves that this [illegible] for [illegible] investor. [illegible] of the [illegible] mortgage-backed [illegible]

[illegible]

appraised value. The FHA mortgage insurance premium is 1/2 of 1% for each year and the insurance must be maintained over the life of the loan.

Background on the Industry and its Operations

There are now fifteen companies writing mortgage insurance in what has become a highly competitive industry. Our assets aggregate approximately $2 billion, and our financial solidity is based on a contingency reserve which, on an aggregated basis at December 31, 1981 was approximately $1 billion. These reserves are accumulated by contributions of 50% of every earned premium dollar into a ten year reserve which cannot be withdrawn without the approval of the state regulator and then only if losses exceed 35% of earned premiums.

Since its creation in 1956, the private mortgage insurance industry has insured over 3 million loans. The bulk of its business has been written in the last 12 years. At December 31, 1970, the industry had insurance in force on approximately $7.3 billion of loans; that figure increased to over $114 billion at December 31, 1981.

Indicative of the role of the private mortgage insurance industry in today's housing market is the record of 1981. According to a March 12, 1982 HUD release, in 1981 $97.3

billion of 1-4 family home mortgages were closed, of which $10.4 billion or 11%, were FHA insured; and $7.5 billion, or 8% were VA guaranteed. Private mortgage insurers insured $18.68 billion or 19.2%, more than the FHA and VA combined.

<u>The Market Served by Private Mortgage Insurance Companies (MIC)</u>

The Subcommittee should be aware of the market which we serve and how it compares with that served by the FHA's unsubsidized home mortgage insurance programs. A comparison follows, based upon 1981 data, to show current performance between the insuring activities of private mortgage insurers and the basic FHA 203(b) program. Unlike previous years FHA does not have available at present data for the last two quarters of the previous year. Therefore, the following statistics are based on the available FHA and MIC data for the first two quarters of 1981.

During this six months, 36% of our insurance involved 95% loans. In that time only 33% of loans in the basic FHA program, section 203, involved a downpayment of 5% or less. The average downpayment for our industry was 12%; for FHA section 203, 11%.

In the first half of 1981, 53% of the mortgages we insured were for less than $50,000. At the same time, 59% of FHA

section 203 mortgages were less than this amount. Our average mortgage in 1981 was $51,640; the FHA's, $44,528. In comparing averages, the Subcommittee should bear in mind two important facts: (1) private insurers are not subject to any mortgage limit, while the FHA is subject to limits that range from $67,500 to $90,000; and (2) 35% of the mortgages we insure are on higher priced new construction while the FHA's percentage for section 203 new construction during the first two quarters of 1981 was 16.7%.

With respect to credit underwriting standards, ours are not materially different from those the FHA applies to its unsubsidized programs. For example, we qualify a family if housing expenses do not exceed 33% of gross income; the FHA uses 35% of net effective income, or income after taxes. While the results of applying a pretax or after tax formula might be significant in individual cases, generally, there is little, if any difference in the family income requirements to purchase a home under either program.

Invariably, an important issue raised in considering a redirection of the FHA's unsubsidized home mortgage insurance programs, is the extent private insurers serve the urban areas. In 1981, 32% of privately insured mortgages involved homes located in urban areas, 61% in the suburbs and the balance in either rural or resort areas. Under the FHA section 203 program, using HUD's own statistics, in 1981, 55% were located in the

urban areas, 42% in the suburbs, and 3% in rural. However, definitions of "urban areas" are not consistent and "urban areas" can be so diverse economically that it is difficult to draw a valid comparison.

We noted that HUD breaks the urban statistics into "core city" and "other urban". In the core city, we note that the FHA's volume there was 2% of total insurance. Unfortunately, I cannot at this time give you comparable statistics from private insurers. I can tell you, however, that the private industry has actively supported a large number of Neighborhood Housing Service Corporations organized under the Community Reinvestment Act, both by way of financial assistance to meet their operating needs and in insuring loans with their respective projects. For example, our industry insured 1,857 mortgages in the revitalization of the Philadelphia urban areas where the loans averaged $17,500 in 1978 to $22,500 in 1981. We are advised by lenders of this Philadelphia Plan that the FHA was only minimally involved.

Private insurers have not penetrated the low income market to any appreciable degree, but neither has the FHA. For example, during the first two quarters of 1981, 2% of the mortgages we insured involved families earning less than $12,000 a year. The FHA 203 program, which breaks at $11,000, shows 1.4% penetration of this low income group using the mortgagor's claimed income which is closest to the "gross income" which we use. These figures, I submit, are not an indictment of either

the FHA's unsubsidized program or the private mortgage insurance business. Rather, it is an indication that, due to today's home affordability problem, loans to borrowers below certain income levels cannot be prudently insured in an actuarially sound program. Insured loans for these borrowers can only realistically be provided through a subsidy program which reflects Congressional policy as to application of resources to be devoted to subsidies. However, these facts rebut arguments that the FHA unsubsidized programs, not private mortgage insurers, serve low income families.

All available data demonstrate that the private mortgage insurance industry and the FHA unsubsidized programs serve essentially the same market. We believe, therefore, based on the capacity we have built since the inception of the industry twenty-five years ago, that a redirection of FHA's unsubsidized role to areas of the market not served by private enterprise would not adversely impact the availability of housing to any segment of the market. Our industry was created on the experience of the FHA, and our success is a testimonial to the contribution made by this agency since its inception 48 years ago.

Industry Capacity to Absorb the FHA Market

I just made the point that our industry has the capacity to absorb the FHA unsubsidized home market, and I would

like to expand on that with specific data. In 1980, this industry's unused insurance capacity was $[illegible] billion. If the FHA had insured no mortgages that year in its unsubsidized mortgage programs, our industry could have absorbed this market and had $[illegible] billion of unused authority remaining. As of December 31, 1981, our unused insurance capacity was $[illegible] billion. I am attaching, as an appendix to this statement, a table showing how the industry insuring capacity is computed. 1981 statistics will not be available for another month.

FY1983 FHA Authorization

For the current fiscal year, the Administration recommended $35 billion for the FHA's mortgage insurance authority. However, the Congress was persuaded by arguments that this reduced level would be harmful to housing. As a result, this limit was increased to $40 billion. According to HUD's current budget summary, the original request of $35 billion would have been more than adequate, as HUD now estimates that the FY1982 commitment level is not expected to exceed $28.6 billion.

We recommend approval of the Administration's request for $35 billion commitment authority for FY1983.

We urge the Subcommittee to recognize that proliferating Federal loan guarantee programs prevent effective

control of government borrowing; and are a major factor in generating upward pressure on interest rates. High interest rates depress all sectors of the housing market and are paid for by all borrowers including those obtaining Federally-guaranteed loans. The Administration deserves your support in its efforts to carefully evaluate the credit needs of FHA and all guarantee programs.

In considering the adequacy of the FHA's $35 billion cap for FY1983, note that private insurers insured 50% more mortgages than the FHA in calendar 1981, and the total dollar volume of mortgages insured by our industry was $18.7 billion - about half of what the Administration has recommended for the FHA.

The Administration's request for a $35 billion cap for FHA mortgage insurance authority is premised on a desire to redirect FHA's unsubsidized home mortgage insurance authority (about 80% of the agency's activity) to areas of the market not served adequately at this time by the private sector. We strongly urge the Subcommittee not to assume that this redirection will constitute a disruption of the mortgage market at this time when the housing industry is in a recession. The private mortgage insurance industry has the capacity to assume most if not all of the present FHA home mortgage insurance activities as explained in detail later in this statement.

Redirection of the FHA

According to the President's Budget Message the Administration proposes to redirect FHA's unsubsidized home mortgage insurance programs to first time homebuyers and inner cities. We strongly recommend that the Congress support this recommendation.

This redirection is consistent with the recommendation of the Task Force on Housing Credit Programs of the President's Housing Commmission (subsequently approved by the Commission) as follows:

> "In view of the development of a strong private mortgage insurance industry, FHA should increasingly complement, rather than compete with, the private market. Further reliance upon the private sector in the insurance of home mortgages should be spurred by public policy designed to redirect the FHA program. FHA should operate on an economically sound basis to provide mortgage insurance only where the private market is unable or unwilling to do so."

Specifically, the Administration's Budget recommends limiting FHA's operations to first time homebuyers and inner cities. While the redirection is commendable and we support the redirection, we do not concede that our industry is unable or unwilling to serve first time homebuyers and inner cities. We are active in both market areas. Thirty-six percent of our

insurance in 1981 involved 5% downpayments and these were principally first time homebuyers. Thirty-six percent of our insurance in 1981 represented 127,248 first time homebuyers; yet in all of the FHA home mortgage insurance programs, the agency in 1981 insured 175,052 mortgages. If two-thirds of these were first time homebuyers, our industry assisted more first time homebuyers in 1981 than the FHA.

The low downpayment first time homebuyer does not represent a neglected market. According to the Primary Mortgage Market Survey of FHLMC dated March 19, 1982, the percentage of lenders offering 95% loans during the week ending March 19 increased sharply to 63.4% from 52.5% the previous month. We are pleased that our industry continues to play a predominant role in assisting first time homebuyers although it is apparent that high interest rates and resultant affordability problems continue to bar many first time homebuyers from the market, regardless of the source of their mortgage insurance. This problem must be addressed by legislation which is now pending before this Subcommittee which would help bridge the affordability gap through interest rate subsidies.

FHA Premiums

The Administration has recommended changes in the FHA premium collection process. Loan servicers are now required to remit insurance premiums to HUD on a monthly basis as collected

We believe that the Administration's recommendation merits the support of the Congress. Certainly, it is more consistent with prevailing insurance business practices and the administrative savings resulting from such a procedure cannot be over-looked.

The FHA Counter-Cyclical Myth

It is argued that the FHA is available throughout the business cycle and therefore must be maintained without any cap, as a counter-cyclical device. This is not a valid argument. Every month for several years, with the exception of the first two months of 1980 when FHA reaped the benefit of its exemption from state usury laws, private mortgage insurers have insured more mortgages than the FHA. Even during the 1973-75 recession our industry insured more home mortgages than the FHA.

According to a Congressional Staff Study dated November 24, 1981 comparing FHA section 203(b) with private insurance, CBO noted as follows:

> "FHA-insured mortgages outstanding declined during the 1973-75 recession, while MIC mortgages outstanding grew, but at a slower rate than during the rest of the decade."

In 1981, certainly a depressed housing year, private mortgage insurers insured 353,466 mortgages on 1- to 4-family homes, more than FHA (175,052) and the VA (142,180) combined.

There is therefore no basis to the assertion that the FHA functions as a counter-cyclical mechanism and is therefore justified in competing aggressively for the same market as that served by private insurers.

The "Crowding-Out" Phenomenon

We believe that a reduction of FHA's competitive activity as the Administration recommends, with a simultaneous reduction in GNMA authority will avoid the crowding-out phenomenon when government and non-government securities seek to tap the same reservoir of capital.

With respect to GNMA we have no reason to doubt the adequacy of the Administration's request for a $35.4 billion limit on the GNMA-MBS program. Of course investors will always prefer securities which are backed by the full faith and credit of the United States. However, the unlimited availability of Federal full faith and credit on mortgage-backed securities is bound to impede the growth of conventional mortgage-backed securities issued by private companies, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation whose securities are not Federally guaranteed.

The unlimited availability of Federally guaranteed mortgage securities competing in a market of limited capital is

bound to not only crowd out non-government paper but exert pressure on interest rates and inflation.

We believe that the Congress should support the Administration's efforts to impose some restraint on the growth of Federal credit, and we believe that this can be accomplished without any disruption of the housing market even during the recovery which we expect in 1983.

FNMA and FHLMC

Section 512 of H.R.5731 would impose a limitation on the participation interest purchased by FNMA and FHLMC. At present these secondary market agencies are permitted by their present charters to purchase a participation up to the maximum established by their respective charters for all mortgages. Because of the rapidly changing conditions in the mortgage market the Congress should point in the direction of less regulation - not more. We view section 512 as an undue restriction on the secondary market. Under this section the participation purchased would have to be added to the portion retained by the lender in applying the statutory maximum. Both FNMA and FHLMC are required by their charters to be governed by the "purchase standards imposed by private institutional mortgage investors". We believe this is sufficient and view section 512 as an unnecessary limitation on the critical secondary market activities of the two

quasi-governmental entities.

The arguments set forth above apply to section 513 of H.R.5731 which would impose a comparable limitation on the second mortgages purchased by FNMA and FHLMC. Second mortgage financing, whether for home improvement, acquisition, or to recoup equity for other purposes, has become widely prevalent in today's market. To restrict FNMA and FHLMC in such purchases shifts second mortgage activity to non-approved and non-supervised lenders with questionable results for homeowners. FNMA and FHLMC are bound by their charters to apply standards of the private investment market and should not be made subject to the rigid limitations imposed by this section.

We strongly recommend that sections 512 and 513 not be approved by the Subcommittee.

Housing Stimulant

H.R.5731 would revive section 235(q) as a stimulant for the depressed housing industry. We do not believe that section 235(q) is an appropriate mechanism and strongly recommend that H.R.5834, also pending before the Subcommittee be considered as the basis for a more realistic means of achieving the objective sought by the Chairman and co-sponsors of H.R.5731. We refer specifically to the low interest rate of 9.5% which would

unnecessarily increase the cost of the bill, and the exclusion of the conventional mortgage from any participation. We also question whether all of the authorized funds should be limited to new construction because the sale of existing homes is a vital ingredient to the revival of home building.

This concludes our testimony, and I welcome the opportunity to respond to any questions.

Chairman GONZALEZ. Thank you, Mr. Waldo.
Mr. Whiteside.

STATEMENT OF WILLIAM A. WHITESIDE, EXECUTIVE DIRECTOR, NEIGHBORHOOD REINVESTMENT CORP.

Mr. WHITESIDE. Mr. Chairman and members of the committee, I would like to submit my prepared testimony for the record and make a very brief comment on the highlights.

I am speaking in support of the committee's recommended authorization of $15.512 million for fiscal year 1983, for the Neighborhood Reinvestment Corp. I am pleased to report that Neighborhood Housing Services programs are currently serving 123 cities and in those 123 cities they are serving 166 neighborhoods. One and a half million people reside in those NHS neighborhoods.

By the end of fiscal year 1982, it will be 180 neighborhoods and 132 cities. Since we began receiving Federal support in 1974, there has been reinvestment in NHS neighborhoods estimated at $1.17 billion, for a Federal funds expenditure of $62 million. Twenty-five additional NHS programs are currently in development and the developmental process is moving as well as can be expected given the current economic climate.

The current economic climate is having a number of impacts on the operation of existing NHS programs and on the development of new ones.

First, of course, the high interest rates are having an enormous impact on the ability and willingness of residents to borrow money to improve their homes. In many NHS neighborhoods, the NHS revolving loan fund is essentially the sole source of housing finance.

The NHS's, however are operating at a peak level of activity in terms of providing services to their clients. These services are to a greater degree than ever providing health and safety improvements in the homes of the NHS residents, and helping to deal with weatherization and emergency repairs.

There is a very high demand for the revolving loan fund because of its ability to make below market loans at flexible rates and terms to the NHS clients. And similarly, there is a high demand in the secondary market for NHS revolving loan fund loans, which is conducted by Neighborhood Housing Services of America.

Our major concern, the major concern of NHS programs around the country today is about operating budgets. One-third of the $10 million contributed toward operating budgets last year by private and local entities was provided by savings and loans and savings banks.

It is very clear, given the condition of the thrift industry, that NHS programs will be suffering a major erosion in this area of their operating budget support. Every program is working diligently to expand the base of private business support for its operating budget. These are annual charitable contributions made to support the operations of the program.

Our response to this, in fiscal year 1982 and in fiscal year 1983, to shift our output somewhat from the development of new pro- to providing increased technical assistance to the existing with a heavy emphasis on technical assistance in fund

raising. A national fund raising campaign is being undertaken by Neighborhood Housing Services of America with a long-term emphasis on broadening the corporate base locally, making NHS known to national corporations, and particularly bringing national corporate support to the NHS secondary market. I should say a word about the secondary market, since a great deal of the testimony you heard this morning is on the major secondary markets and this is a very small one.

Since it began in 1974, the NHSA secondary market has been able to buy $4 million in loans from local NHS programs. In 1982 if the capital can be raised, it will buy more than that total amount in 1 year. We see an even greater demand in 1983.

This secondary market is not based on borrowed funds. It is based on contributed capital and the loans purchased from the local NHS don't fit the model of any typical loans sold in a secondary market. They are by nature, loans to people who are unbankable.

Chairman GONZALEZ. Mr. Whiteside, pardon me for interrupting you. We have an unexpected development and I have to leave to be on the House floor when the House opens up.

So, we can offer some motions with respect to the emergency extension of the 235 program. So, I am turning the Chair over to our very able colleague, Mr. Vento and hopefully we will be back as soon as we get this motion.

So, that is the reason I was interrupting.

Mr. WHITESIDE. Certainly.

Mr. VENTO. Please continue, Mr. Whiteside.

Mr. WHITESIDE. The clients of NHS revolving loan funds are individuals who are by definition, unbankable and the average rates on NHS loans have been about 5½ percent. The way the secondary market has operated is that securities have been offered to institutional investors, backed by the loans purchased from the local NHS's over-collateralized by 25 percent. Further guarantees have been provided and the loans are also purchased with recourse. This recourse is perhaps the greatest guarantee to the purchasers of the mortgage backed securities offered by Neighborhood Housing Services of America.

The institutional investors purchasing these securities have been treating them as social investments and making their purchases at below market rates. The most recent success in example of this is the offer by the Prudential Insurance Co. to purchase, over the next 2 years, $5 million in secondary market securities of Neighborhood Housing Services of America at a 5½ percent rate with a 25-year term.

The discounted value of that interest give up to the Prudential Insurance Co. is equivalent to a $2.1 million contribution to Neighborhood Housing Services.

We are making steady progress in our work to [illegible] basic NHS program by providing additional tools [illegible] improvement program has produced $[illegible] million in [illegible] and produced the revitalization of 1,500 units, much of it in a difficult interest rate climate. In the pipeline right now [illegible] apartment improvement programs around the country. [illegible]

buildings containing 3,985 units which require $12 to $15 million in rehabilitation work.

With great difficulty and care, the participating lenders are fashioning loans to finance the rehabilitation of these buildings. When the interest rates drop just a few points, this activity is going to move forward at a very rapid pace.

The owner-built housing effort which was begun in Oakland, Calif., where moderate income homeowners with the assistance and supervision of NHS literally built their own homes, is now being expanded to other parts of the country. We are getting our first experience in Hartford, Conn. trying this program out where there is a shorter construction season, we look forward to seeing what it is possible to accomplish in a variety of regional settings. We are very encouraged by the neighborhood commercial revitalization activity which is going forward in Bridgeport, Conn., and Atlanta, Ga. We will be undertaking two more of these programs this year.

Then, finally, our Mutual Housing Association demonstration being conducted initially in Baltimore, Md., is moving at a excellent rate. This demonstration was begun with the encouragement of this committee. We have made our first report to Congress as requested last September.

The demonstration was undertaken in response to the observation that there is little or no multifamiliy construction or rehabilition going on and in NHS neighorhoods and for income levels below the national median income, virtually no increase in rental capacity whatever.

Mutual housing associations will provide a setting in which, while the occupants will have no ownership interests, there will be a homeownership quality through their participation in management, maintenance, and the operational decisions of the association.

The Mutual Housing Association will be a continuous producer of housing for moderate-income families and we will be experimenting with a front-end subsidy through these publicly accountable, private nonprofit organizations.

We are going to the private philanthropic community for funding of the subsidy on the first demontrations, and we look forward to our experience during the next 2 or 3 years providing useful information to the Congress as it looks at future methods of funding-assisted housing.

With that, Mr. Chairman, I will conclude my comments and would be pleased to accept questions.

[Mr. Whiteside's prepared statement, on behalf of the Neighborhood Reinvestment Corp., follows:]

STATEMENT OF

WILLIAM A. WHITESIDE, EXECUTIVE DIRECTOR

NEIGHBORHOOD REINVESTMENT CORPORATION

BEFORE THE

HOUSE BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

ON

NEIGHBORHOOD REINVESTMENT CORPORATION

FISCAL YEAR 1983 AUTHORIZATION REQUEST

MARCH 3, 1982

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Mr. Chairman and Members of the Committee. It is a privilege to appear before you today to testify on the Fiscal Year 1983 authorization request of the Neighborhood Reinvestment Corporation. In my remarks, I shall cover the following areas:

Problem Being Addressed
Neighborhood Reinvestment Corporation's Role
Program Highlights and Impact
Cost-Effectiveness of Neighborhood Housing Services
Impact of Current Economic Climate
Corporate Fund Raising Assistance
New Programs' Progress
Mutual Housing Association Demonstration

Supplemental materials are included in the Appendices to my printed testimony. Further background on the Corporation can be found in Appendix A.

INTRODUCTION

The current economic climate is having a growing impact on Neighborhood Housing Services (NHS) programs. They are basically sound and operating at full momentum, with their revolving loan funds being utilized at an all-time peak rate, making loans at the below-market rates which NHS clients can afford. Conventional lending is, of course, at an extremely low level, and NHS programs are in many cases the only credit source serving the neighborhoods. Inflation has eroded the purchasing power of individuals on fixed incomes and at the same time, high interest rates have reduced the ability of neighborhood residents who would normally have been bankable to borrow to make needed repairs. This larger number of loans, combined with loans for larger amounts due to increased costs of rehabilitation, is putting increased strain on NHS revolving loan funds

and dramatically increasing the demand on the secondary market operated by Neighborhood Housing Services of America.

Rehabilitation work for unbankable homeowners, emphasizing emergency repairs and weatherization, has NHS staffs operating at a very high level of activity in their counseling, specification writing, loan packaging, and supervision of rehabilitation activity.

Most NHS programs are grappling with ways to sustain adequate operating budgets. While thrift institutions have been maintaining their support of NHSs astonishingly well given their current circumstances, savings and loan and savings bank contribution levels are dropping and a number of thrift institutions have had to discontinue their contributions entirely. We anticipate that mergers will also have the effect of eroding the base of the thrift institutions' support. Every NHS board of directors, therefore, is genuinely concerned about the present and future availability of resources. Efforts are underway to broaden the local NHS partnerships, adding other private corporations to broaden the primarily thrift institution and commercial bank base of previous years.

Programs which we are now calling Problem Properties Strategies, including Home Ownership Promotion and Rehabilitation and Sale programs have also been slowed by the high interest rates. The prospective owners of these rehabilitated properties, who would be bankable in normal times, are more often than not unable to handle the monthly payments at today's interest rates. Apartment Improvement Program rehabilitation activity has also been slowed to only a handful of rehabilitations during the past six months.*

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* There have been a few breakthroughs, however, such as the $6 million private financial package put together through a special partnership effort in the Bronx. When finalized, a 713-unit apartment complex for low-income working class families will be substantially rehabilitated. In another Apartment Improvement Program, a $590,000 loan package has recently been approved to implement improvements on a 140-unit building. The total restructured conventional mortgage is $1,285,000.

Overall, our response to program needs growing out of inflation, high interest rates and the current recession has been to shift staff effort from program development to training, technical assistance and the development of additional private sector financial resources. We are also actively pursuing a national fund raising strategy aimed primarily at reaching the secondary market to meet the long-term needs of NHS programs to sell revolving loan fund loans at below-market rates.

PROBLEM BEING ADDRESSED

The problem being addressed by the Neighborhood Reinvestment Corporation is disinvestment in older neighborhoods. The physical characteristics of a neighborhood suffering disinvestment include under-maintenance of structures, declining or stagnant market values, vacant and abandoned buildings, demolition of structures, lack of vitality of neighborhood commercial areas and limited public services and under-maintenance of the public infrastructure.

Accompanying these physical conditions - partially causing the conditions and partially being caused by the conditions - are problems of a deterioration of the social fabric of the neighborhood. These include, in varying degrees, reduced homeownership, increased transiency, increased crime, arson, etc.

Residents of these neighborhoods may feel a sense of alienation from the broader society. They perceive a kind of second-class economic citizenship - with many business services not made available in their neighborhood by reputable 'main line' businesses. They also feel a second-class citizenship in regard to the quality and quantity of municipal services, public schools and public investment in their neighborhoods.

Neighborhoods are affected by these conditions in varying degrees. A neighborhood severely impacted by all of the above problems might be beyond salvage

given the present state of the art. Neighborhoods with varying lesser degrees of problems can be "turned around" through appropriate reinvestment strategies and the utilization of the appropriate amount of resources. Neighborhood Housing Services programs operate in neighborhoods with defined boundaries characterized by (a) a housing stock showing evidence of deterioration and lack of maintenance; (b) an inadequate degree of mortgage and home improvement activity; (c) a substantial degree of homeownership; and (d) an income mix in the neighborhood as low as resources will permit (very low family incomes and high repair costs will require raising additional resources for revolving loan funds and staffing).

We estimate that several hundred such neighborhoods throughout the nation are at pivot points where intervention by a local partnership equipped with NHS tools can tip the balance from decline to revitalization.

The problem being addressed has been intensified and complicated by current economic conditions. High rates of inflation have eroded the purchasing power of neighborhood residents, while at the same time increasing the costs of needed repairs. Similarly, high utility costs have exacerbated the problem, requiring, in areas of climatic extremes, significant weatherization outlays in order to reduce annual utility expenditures.

Central to the problem of disinvestment is the lack of confidence in the neighborhood by the residents themselves, the private sector, and governmental bodies. Because of this factor and the interactive nature of causes and effects, it has been difficult for any one sector to address the problem. The private sector - particularly financial institutions which have been widely criticized for "redlining" - cannot affect the underlying conditions simply by changing lending policies or insurance underwriting standards. Residents lack the

resources to pull themselves up by their bootstraps however much they may be willing to try; and few governmental approaches have been able to deal comprehensively with the problems and to marshal the public, private and citizen resources required.

THE NEIGHBORHOOD REINVESTMENT CORPORATION'S ROLE

Neighborhood Housing Services provides a comprehensive, coordinated strategy which simultaneously rekindles confidence in the neighborhood by all significant actors and successfully addresses the problem of disinvestment in older neighborhoods.

In the Neighborhood Reinvestment Corporation Act, Congress found that "the Neighborhood Housing Services demonstration of the Urban Reinvestment Task Force has proven its worth as a successful program to revitalize older urban neighborhoods by mobilizing public, private and community resources at the neighborhood level; and the demand for Neighborhood Housing Services programs in cities throughout the United States warrants the creation of a public corporation to institutionalize and expand the Neighborhood Housing Services programs and other programs of the present Urban Reinvestment Task Force." The act further states that "the purpose of this title is to establish a public corporation which will continue the joint efforts of the Federal financial supervisory agencies and the Department of Housing and Urban Development to promote reinvestment in older neighborhoods by local financial institutions working cooperatively with community people and local government and which will continue the nonbureaucratic approach of the Urban Reinvestment Task Force, relying largely on local initiative for the specific design of local programs."

The main vehicle employed by Neighborhood Reinvestment for addressing the problem of disinvestment in older neighborhoods is the Neighborhood Housing Services program (see Appendix B). These local, nonprofit corporations are establishing themselves as continuing institutions in 120 cities, committed to reinvestment in a series of neighborhoods. NHS programs are created by Neighborhood Reinvestment through a developmental process which involves building a working partnership among the local business and financial institution leaders, government officials and residents of a community (see Appendix C). The majority of human and financial resources utilized are derived locally, with Neighborhood Reinvestment staff providing expertise in group educational processes, organizational development and technical areas. In eleven years of work in this area, the Neighborhood Reinvestment Corporation and its predecessors, the Urban Reinvestment Task Force and the Center for Executive Development of the Federal Home Loan Bank Board, have developed NHS programs in 163 neighborhoods nationwide.

Neighborhood Reinvestment's function of providing neighborhood program support, training and technical assistance guarantees that once developed, these programs can remain viable and effective. Direct staff assistance ensures that a local NHS program can draw upon experienced personnel to solve difficult technical problems. In the event of unexpected local staff turnover, an interim executive director can help an NHS weather what could otherwise have been a major crisis. Training workshops and conferences help build and enhance the skills of local NHS staff members in areas essential to the successful operation of their programs. This includes administrative and executive skills as well as technical assistance.

A secondary market provides a flow of capital into local NHS revolving loan funds, tapping institutional investor resources to leverage capital provided by the Neighborhood Reinvestment Corporation.

Finally, Neighborhood Reinvestment provides, through an organized process, programmatic tools to supplement this basic NHS model. This process includes: (1) the identification and monitoring of promising local efforts which are successfully dealing with neighborhood problems beyond the scope of the basic NHS program; (2) testing of these new tools in additional locations; and (3) making the new programmatic components available to NHS neighborhoods which require them in order to successfully revitalize their neighborhoods.

These new tools enable NHSs to deal with rental housing, more distressed neighborhoods, neighborhoods with higher proportions of renters and apartment buildings, more blighted buildings, scattered vacant lots, blighted commercial areas, etc.

PROGRAM HIGHLIGHTS AND IMPACT

By the end of FY 1982, Neighborhood Housing Services programs will be serving approximately 130 neighborhoods in 132 cities. NHS programs will be operating in approximately 43 states and the District of Columbia.

NHS programs operate in most of the large cities. Of the 57 cities over 250,000 population, at least 45 will have NHS programs operational or in development by the end of FY 1982. At the other end of the scale, among a growing number of small cities served, NHS will constitute the main neighborhood revitalization and housing rehabilitation activity in nearly a score of cities under 30,000 population. One-fifth of the neighborhoods have populations 85% or more minority. One-fifth of the neighborhoods have populations 15% or less minority and the other three-fifths of NHS neighborhoods have populations which are between 15% and 85% minority. The neighborhoods served range from neighborhoods as small as 500 dwelling units to neighborhoods as large as 11,000 dwelling units. The median

neighborhood size is 2,500 units. Populations are as small as 1,500 and as large as 27,000. Approximately 1,500,000 people live in NHS neighborhoods.

A report on NHS, Describing Target Neighborhoods, prepared for the Department of Housing and Urban Development, provides an overview of conditions in neighborhoods in which the program is operating. The report shows that in terms of standard social and economic characteristics, most neighborhoods which later were to be served by NHSs, were declining relative to their metropolitan areas between 1950 and 1978. Many suffered dramatic deterioration. For example, income and education levels, rent levels and property values all fell relative to metropolitan areas and national levels. Furthermore, housing conditions fell to levels generally worse than those in the rest of the city.

The HUD study was able to report initial evidence that NHS neighborhoods began improving during the later part of this period. Between 1970 and 1978, average property values in 15 out of 20 sample NHSs increased relative to their SMSAs.

The table in Appendix D, which is based upon the Corporation's own records, compares the median household incomes in NHS neighborhoods with city-wide levels. The average to date has been 84%. These figures represent levels at the time of the development of each program. In keeping with the basic program model, most NHSs have chosen neighborhoods where the income mix permits a large proportion of homeowners to repair and maintain their homes without extensive subsidy.

A study conducted by Neighborhood Reinvestment, entitled Neighborhood Partnerships in Action, is an attempt to determine the experience of the NHS partnership model and to report on their program experience to date. Specifically, it was designed to provide a description of NHS neighborhoods, analyze the change in investment levels and other proxies for local market activities, assess the

extent to which NHS is capable of delivering programs and generating new ideas, and the extent to which the program is transferable to a wide range of neighborhoods. In addition, two of the Corporation's newer programs, the Apartment Improvement Program and the Home Ownership Promotion program, were examined. The study was based on a field survey of 11 NHS programs, three Apartment Improvement Programs and two Home Ownership Promotion programs, as well as survey materials made available by HUD.

On the basis of data available for 1979, the Corporation's study estimates that total reinvestment that year — by owner-occupants, alone — in 126 NHS neighborhoods was as high as $130 million. This total is based on an average NHS neighborhood of 2,500 households, half of whom are owners, 54% of whom invested in their property for an average of $1,350. The average investment figure was based on survey data from a sample of 21 neighborhoods which showed owner-occupant reinvestment in an amount double what one would expect in a neighborhood having no program. The $130 million total does not include investment by non-occupant owners, public improvements or improvements made by institutions and nonprofit organizations.

Drawing upon the analysis of this study as well as Neighborhood Reinvestment's program data, we estimate that in a five and one-half year period more than $11 million in reinvestment may occur in an NHS neighborhood of average program difficulty, with average program resources. Eighty percent represents private reinvestment, most of which is made by individuals in mortgages, home improvement loans, or direct cash expenditures within the neighborhoods. The value of 'sweat equity' is not included here. Most of the rest of the reinvestment, 18%, is made by state and local governments in the form of capital

improvements in the neighborhoods and local public activity. (In-kind contributions and staff time are not typically reflected.) One cannot, of course, attribute the full $12 million to the presence of NHS since some of this investment would likely occur even in the absence of a program. The neighborhoods when selected are, however, generally below average in reinvestment activity and mortgage activity.

COST-EFFECTIVENESS OF NHS

We believe we have exercised good stewardship over the resources made available to us.

The cost-effectiveness of our work in establishing Neighborhood Housing Services programs and providing them with grants and technical assistance is illustrated in the following table. As the table shows, it is projected that $119 million will have been made available in support for local NHS program activities by the end of Fiscal Year 1982. These resources come from a variety of sources, including: local government contributions to developmental costs, revolving loan funds, and expenditures for code inspections; primarily private sector contributions to operating budgets; private sector, foundation, and Neighborhood Reinvestment Corporation grants to revolving loan funds; and below-market security purchases by institutional investors. These resources are exclusive of the tens of thousands of volunteer hours of activity by the NHS participants in 163 neighborhoods in 120 cities. The table projects $1,171,000,000 in reinvestment occurring in NHS neighborhoods through Fiscal Year 1982. This is exclusive of the value of the "sweat equity" of thousands of homeowners' improvement efforts. The total in Federal funds expended or committed by the Neighborhood

ESTIMATE OF THE TOTAL REINVESTMENT
OCCURRING IN
NEIGHBORHOOD HOUSING SERVICES PROGRAM NEIGHBORHOODS
THROUGH FISCAL YEAR 1982

<u>Support for Local NHS Program Activity</u>

Contributions to developmental costs primarily by local government		$ [illegible]
Contributions to NHS operating budgets primarily by financial institutions		[illegible]
Contributions to NHS revolving loan funds (local government, Neighborhood Reinvestment Corporation, foundation, other sources)		54,000,000
Purchase of NHS loans by Neighborhood Housing Services of America		5,000,000
City expenditures for code inspections		30,000,000
	TOTAL	$ [illegible]

<u>Reinvestment in NHS Neighborhoods*</u>

Loans made through NHS loan funds		$ [illegible]
Loans made through financial institutions by referral from NHS		100,000,000
Loans made by city/state loan programs		25,000,000
New mortgages written in NHS neighborhoods		[illegible]
Other rehabilitation financed**		[illegible]
Capital improvements in NHS neighborhoods		[illegible]
	TOTAL	$[illegible]

<u>Federal Investment</u>

Federal funds expended or committed to date (Urban Reinvestment Task Force demonstration grants 1974-1979 of $[illegible]; FY 80 - FY 82 appropriations of $[illegible])		$ [illegible]

*Estimates are based on documented activity through December, 1981; data collected by Urban Systems Research and Engineering, Inc. under contract to HUD, and through sample data collected for a research report entitled, <u>Neighborhood Partnerships in Action</u>, Neighborhood Reinvestment Corporation, August, 1981. The full amount of reinvestment cannot, of course, be attributed to the presence of NHS, as some level of reinvestment would occur even in the absence of a program. The neighborhoods when selected, however, are deficient in reinvestment activity.

**Work financed by individuals through savings or money borrowed independently from financial institutions.

Reinvestment Corporation and its predecessors through the end of Fiscal Year 1982 will be $62 million. This works out to a leverage on Neighborhood Reinvestment's expenditure of Federal dollars of 19-to-1, to date. Leverage over the average 5-1/2 years life of an NHS program serving an average neighborhood of 2,500 homes, with average resources and average program difficulty, is projected at 39-to-1 as reported last year. The 19-to-1 ratio on our activity to date is reflective of the projected 180 neighborhood programs, including 59 programs which are under two years old.)

IMPACT OF CURRENT ECONOMIC CLIMATE

As noted earlier, the current economic climate is having a mixed impact on NHS programs. Operating at full momentum, with their revolving loan funds being utilized at a peak rate, the NHS programs in many instances are the only credit resource serving the neighborhood in an era of very little conventional lending. The reduced availability of governmental resources will be increasingly felt and every NHS is stretching to its creative limit to corral and harness resources for revitalization of the neighborhood or neighborhoods it serves.

Most NHS programs are looking for new ways to sustain an adequate level of operating funding. This is not only to substitute for the inevitable reduction in savings and loan and savings bank contribution levels, but to provide expanded resources to cover operating budgets, revolving loan fund needs and to fund strategies for overcoming "sticking points" in particular neighborhood revitalization strategies. An early success in the broadening of this base of support was the Prudential Insurance Company's commitment to purchase $5 million in first mortgage loans (at 9½% for 25 year terms) to facilitate the Problem Properties Strategies created to deal with such "sticking points".

Neighborhood Reinvestment's efforts are striving towards providing increased staff assistance to help existing NHS programs achieve these objectives -- slowing somewhat our development of NHS programs in new cities.

At the beginning of this Fiscal Year, we restructured our field operations to strengthen our delivery of services. This includes the creation of a second deputy executive director position responsible for field operations as well as redefining many field positions. Training is underway to strengthen the ability of our field staff to provide fund raising and other technical assistance (for details on neighborhood support, training and technical assistance, please see Appendix E).

The following table compares the outputs we are recommending for Board approval for Fiscal Year 1982 and Fiscal Year 1983.

	Request '82	Current Est. '83	Request '83
NHS Programs (New & Expansions)	24	17	13
Apartment Improvement Programs	4	4	4
Problem Properties Strategies	4	4	4
Insurance Full Partnerships	3	4	4
Owner-Built Housing	2	4	4
Urban Lender Programs	3	0	0
Energy Conservation	1	2	2
Commercial Revitalization			
New Program Development	1	2	2
Intense Technical Assistance	0	10	10
Neighborhood Preservation Projects (Grants $000s)	$700	$408	$200
Neighborhood Program Support, Training and Technical Assistance	150	172	189
Neighborhood Housing Services of America (Grants $000s)	$800	$600	$550

These figures result from a shift from development of NHS programs in additional cities, and from Neighborhood Preservation Projects (our research and development function) into providing increased technical assistance to a growing number of neighborhood programs. The shift is planned for the latter half of Fiscal Year 1982 and for Fiscal Year 1983. You will note that we have shown a reduction of support for the secondary market in expectation of private fund raising providing a large supplement to our funding role.

The shift in effort implied in these recommended allocations is an adaptation to current economic conditions, and still subject to review by our Board. Should the conditions change -- for better or worse -- we will recommend further adaptations.

CORPORATE FUND RAISING ASSISTANCE

We are also actively pursuing a national fund raising strategy aimed primarily at readying the secondary market to meet the long-term needs of NHS programs to sell revolving loan fund loans at below-market rates. The requirements of the NHS secondary market, operated by Neighborhood Housing Services of America (NHSA), for capital, operating income, and funds to cover the difference between the average yield of loans purchased and the average yield required by an institutional investor, are significantly exceeding Neighborhood Reinvestment's budgetary resources. The requirements of local NHS programs for hands-on technical assistance in fund raising are also beyond our resources to supply fully; therefore, a portion of the national fund raising proceeds will be earmarked for NHSA management assistance to local, regional and state fund raising efforts aimed at broadening the base of support for operating budgets, revolving loan funds, and special projects for groups of NHS programs.

NEW PROGRAMS' PROGRESS

We continue to make good progress in the following areas: Apartment Improvement Programs, Owner-Built Housing, Energy Conservation and Neighborhood Business Centers. Even with today's interest rates, Apartment Improvement Programs, for example, have put together $25 million in documented new mortgages, revitalizing 5,300 units. Presently in the pipeline are 37 buildings containing 1,985 units, requiring $12-$15 million in rehabilitation.

We expect the Owner-Built Housing program to be introduced into four additional NHSs. This program enlarges homeownership in NHS neighborhoods for families collectively building their own homes with supervision, coordination, and technical assistance provided by the NHS. The initial program and its first replication were undertaken in California. The challenge this year is to adapt the program to different building styles and shorter construction seasons.

Energy conservation is becoming an increasingly significant activity. Our training program for executive directors and rehabilitation specialists stresses weatherization and energy conservation objectives in all rehabilitations. We have also worked with several NHSs across the country in developing comprehensive energy conservation programs which, with the assistance of a Ford Foundation grant, are being replicated in three NHS neighborhoods and two Apartment Improvement Programs. The Ford Foundation grant has also assisted us in beginning a journal on energy conservation techniques and strategies for NHS and Apartment Improvement Programs.

After working since 1978 to develop a model neighborhood commercial revitalization program, we now have the satisfaction of having a comprehensive program to offer in this area. In addition to the pilot program in Atlanta and Bridgeport,

we will be starting development of Neighborhood Business Centers in two other cities. We have also developed the staffing capacity to provide intensive technical assistance to ten NHS programs with commercial revitalization needs. For more details on these and other neighborhood programs, please see Appendices F - L.

MUTUAL HOUSING ASSOCIATION DEMONSTRATION

This Committee indicated a particular interest in our Mutual Housing Association demonstration, encouraging it in the Housing and Community Development Act of 1980. A report to Congress on progress with the demonstration was made on September 30, 1981.

The goals of the Mutual Housing Association demonstration are:

- To review and analyze the Western European Mutual Housing Association model.
- To synthesize from Western European experience a program adapted to American needs and customs.
- To create a Mutual Housing Association developmental process which can be systematically applied to produce similar programs in other communities needing them.
- To carry out the developmental process in a sufficient number of locations to be able to recommend it as a reliable method of replication.
- To obtain practical experience in the physical development and the management and maintenance of complexes of dwelling units utilizing the Mutual Housing Association organizational model and the associated financial concepts.
- To obtain practical experience in monitoring, auditing and providing technical assistance to operating Mutual Housing Associations.
- To develop a sufficient number of Mutual Housing Associations to test the concept in several regions, on different housing types, and on both new construction and rehabilitation.

The demonstration was designed to exclude use of any present form of housing subsidy, so as not to influence the results.

The term Mutual Housing Association has been used to describe a number of differing conceptual approaches, in this country and in Canada, England and Western Europe. Our goal in the demonstration has been to synthesize from the West German experience (with which we had become familiar in earlier transfers of technology) a form of organization and approach to providing housing which would be appropriate to neighborhoods such as those served by Neighborhood Housing Services programs and consistent with the institutions, values and customs of the United States. In doing this, we reviewed a number of West German organizations, focusing on the scale and spirit of community which best fit the NHS partnership model. We then drew out of this experience elements which would fit the American culture and discarded those which did not seem appropriate to an American model. It was also necessary to add a financial element to the model suited to today's high cost, high interest rate economic climate.

The Mutual Housing Association model being tested is a uniquely synthesized creation especially designed for utilization in moderate income neighborhoods in United States cities in the decade of the 80's. Considerable effort went into designing the model. The team of Neighborhood Reinvestment Corporation and Neighborhood Housing Services of America staff which visited West Germany carefully pieced together the appropriate elements of the West German experience and tested the evolving model with scores of knowledgeable American experts in various facets of housing. The model was also tested against the knowledge of NHS partnership members of the desires and needs of NHS neighborhood residents. While we view this model with considerable confidence, it should not be considered a static

concept as it will be continually tested and refined in the crucible of day-to-day experience during the coming months and years in the demonstration phase.

The model is designed to address the form of organization needed, methods of providing technical assistance and guaranteeing public accountability, and a form of public assistance which would: a) be workable in present day market conditions, and b) be more cost-effective than alternative approaches.

The model has the following characteristics:

1. The Mutual Housing Association will serve populations typical of NHS neighborhoods. (Currently the average NHS neighborhood median family income is 84% of the city-wide median family income. NHS neighborhoods also exhibit a substantial proportion of homeownership - currently averaging 58% - and although specific data are not yet available, the median family incomes of the neighborhood non-owner occupants are believed to be less than 80% of the city-wide median family income.)

Should a voucher system of housing assistance be implemented, Mutual Housing Associations would be able to reach lower income families without sacrificing the financial integrity of the model.

2. The Mutual Housing Association is a nonprofit corporation with a Board of Trustees made up of resident and pre-resident members, and community interest members drawn from the local NHS partnership.

3. Its initial sources of capital include membership fees, capitalization grants, and conventional mortgages. After a period of successful operation, the association will also be able to utilize self-generated capital.

4. The Mutual Housing Association's mission includes:

   - Serving as a continuous producer of housing - both through new construction and through rehabilitation of existing distressed units.

   - Owning and serving as the continuous operator of the housing produced and providing high quality management and maintenance services.

   - Providing housing opportunities at neighborhood market levels, for residents typical of NHS neighborhoods.

   - Providing long-term shelter for resident members under conditions which, while not conveying individual ownership rights, provide many of the qualities of homeownership.

For the Mutual Housing Association to serve lower income families and individuals, a method for reducing the cost of financing and development is required. We are proposing that a front-end capitalization grant be utilized.

We are proposing to national foundations and corporations that they participate in the creation of the Mutual Housing model through the provision of the capitalization grant for the initial Baltimore development. All of the other resources and commitments for the initial phase are in place.

Baltimore, Maryland was selected as the site for the first demonstration. This selection was based upon enthusiastic cooperation of the NHS partnership, the cooperative stance of the city government, and the availability of a suitable development site.

In late 1980, work began on the Mutual Housing Association in the Govans neighborhood in northeast Baltimore and the initial partnership group was drawn from the existing Govans NHS partnership. The Govans neighborhood is predominantly black, with a wide variety in housing stock. The median family income is 86% of the Baltimore city-wide median.

The NHS developmental process has been carefully adapted to the Mutual Housing Association and the first workshop was held in September, 1981. After one and one-half days of discussion the partnership unanimously agreed to go forward with forming a Mutual Housing Association in Baltimore. All present agreed that they wished to become charter members of the Association. Five partnership committees were formed through which organizational development activities have taken place.

Over the past seven months these committees have developed policy recommendations on membership, physical development, organizational structure, operations and public relations. Committee progress reports were presented in December and in March another workshop was held at which time committee recommendations were made to the partnership. Over 60 members of the partnership, including potential residents of the Mutual Housing Association, religious leaders, members of the Govans NHS and NHS of Baltimore, financial institution and real estate professionals, city government representatives and neighborhood leaders were present to discuss the proposals and make further suggestions to the committees. Incorporation and election of board members are planned for late spring.

While the Mutual Housing Association organizational form was being developed, an interim group was also working with Neighborhood Reinvestment and Neighborhood Housing Services of America staff towards the selection of a first site for physical development. The local NHS partnership, Baltimore housing leaders, city and pro bono technical consultants provided input in the selection of a 10-acre vacant lot as the site for the eventual 150 Mutual Housing Association units.

The land has been optioned, and the partnership group has provided input to the architect in developing a site plan and working floor plans for the two-story brick townhouse units. Necessary zoning clearances have been obtained,

engineering is [illegible], and it is [illegible] phase of [illegible] in the late spring [illegible]

Support for the [illegible] in the traditional [illegible] of [illegible] fasmor the [illegible] have already [illegible] the [illegible]

[illegible]

[illegible]

Associations will be going through real world trials and errors on a carefully monitored demonstration basis during the early 1980's. This will provide a base of actual experience for Congress's review in considering alternative Federal responses to the housing needs of American families in the mid-1980's and beyond.

NEIGHBORHOOD REINVESTMENT CORPORATION

General

The Neighborhood Reinvestment Corporation was created by the Neighborhood Reinvestment Corporation Act (Title VI of the Housing and Community Development Amendments of 1978, Pub. L. 95-557, Oct. 31, 1978) to continue and expand the work of the Urban Reinvestment Task Force, which was a joint effort of five Federal financial supervisory agencies and the Department of Housing and Urban Development to promote reinvestment in neighborhoods. Section 604(a) of that law, as amended by the Housing and Community Development Act of 1980, Pub. L. 96-399, Oct. 8, 1980, states that:

1. The corporation shall continue the work of the Urban Reinvestment Task Force in establishing Neighborhood Housing Services programs in neighborhoods throughout the United States, monitoring their progress, and providing them with grants and technical services.

2. The corporation shall continue the work of the Urban Reinvestment Task Force in identifying, monitoring, evaluating and providing grants and technical assistance to selected neighborhood preservation projects which show promise as mechanisms for reversing neighborhood decline and improving the quality of neighborhood life.

3. The corporation shall experimentally replicate neighborhood preservation projects which have demonstrated success, and after creating or using development processes, bring the new programs to neighborhoods throughout the United States which in the judgment of the corporation can benefit therefrom, by providing assistance in organizing programs, providing grants in partial support of program costs, and providing technical assistance to ongoing programs.

4. The corporation shall continue the work of the Urban Reinvestment Task Force in supporting Neighborhood Housing Services of America, a nonprofit corporation established to provide services to local neighborhood housing services programs, with support which may include technical assistance and grants to expand its national loan purchase pool, and may contract with it for services which it can perform more efficiently or effectively than the corporation.

The Corporation's Board of Directors is composed of:

Richard T. Pratt, Chairman
Chairman
Federal Home Loan Bank Board

J. Charles Partee, Vice Chairman
Member, Board of Governors
Federal Reserve System

Samuel R. Pierce, Jr.,
Secretary
U.S. Department of Housing and Urban Development

C.T. Conover
Comptroller of the Currency

William M. Isaac
Chairman
Federal Deposit Insurance Corporation

Edgard F. Callahan
Chairman
National Credit Union Administration

These Board Members actively participate in governing the affairs of the Corporation. Membership on the Board of the heads of the Federal financial regulatory agencies is critically important to the success of the Neighborhood Reinvestment Corporation. They and their district Federal Home Loan Bank Presidents or Federal Reserve Bank Presidents or Regional Directors provide entre' to the top leadership of the commercial banks, savings banks, savings and loans and credit unions of the United States, applying moral suasion to encourage involvement of these institutions in local neighborhood partnerships.

The Office of Neighborhood Reinvestment of the Federal Home Loan Bank System provides administrative support and staff to assist in accomplishing the goals of the Neighborhood Reinvestment Corporation.

Mission

The mission of the Neighborhood Reinvestment Corporation is to:

1. Assist local communities to revitalize neighborhoods for the benefit of current residents.

2. Develop, through educational processes, working partnerships of residents, local government officials and financial institution representatives to accomplish neighborhood revitalization.

3. Discover, test and replicate neighborhood program models which promote reinvestment in neighborhoods; and which

   (a) exert a long-term stabilizing influence on the neighborhood lending environment, and

   (b) lead to a perceived improving quality of life which will strengthen weak demand factors in the neighborhood real estate market.

4. Provide ongoing supportive services to local programs to ensure their continuing effectiveness.

<u>Objectives</u>

The Neighborhood Reinvestment Corporation's objectives are to

1. Develop local Neighborhood Housing Services programs which manage comprehensive, coordinated reinvestment strategies.

2. Seek out additional promising strategies and techniques for reversing factors which negatively impact the quality of life in neighborhoods.

3. Select the most promising strategies and techniques, and

   a. monitor them and evaluate their effectiveness and replicability,

   b. replicate them on a pilot basis in varying environments, working out systematic developmental educational processes, and

   c. replicate them in additional communities where they are needed.

4. Provide supportive services to local programs to ensure their continuing effectiveness, including

   a. information and training for local partnership members,

   b. training and education for local program staff,

   c. technical materials and systems for local programs, and

   d. a secondary market for revolving loan fund loans of local programs.

5. Disseminate information.

6. Provide an effectively administered organization to accomplish the Neighborhood Reinvestment Corporation's goals and objectives.

NEIGHBORHOOD HOUSING SERVICES MODEL

The Neighborhood Housing Services program is a comprehensive coordinated reinvestment strategy to produce neighborhood revitalization for the benefit of current residents. This strategy, carried out by a partnership of neighborhood residents, business and financial leaders and local government officials, systematically improves housing and upgrades neighborhood amenities. The goal of NHS is to exert a long-term stabilizing influence on a neighborhood, reversing decline and reducing risk for lenders, insurers and others doing business in the neighborhood.

For this strategy to have the desired long-term results, and for there to be a renewal of confidence, an improved quality of life must be perceived in the neighborhood by the residents and by the larger community. This perception reverses the weak demand factors which contribute to the disinvestment and brings about a strengthened real estate market. Success or "completion" is therefore measured in terms of that perception and the ability of the neighborhood to sustain a stable community standard of maintenance.

To accomplish this goal the program has the following basic components and services:

Private/Independent: Funding for the operating budget is provided by participating financial and business organizations. Government funds are contributed to the revolving loan fund and in some cases have been contributed as a portion of the operating funds. Strong efforts are made to ensure that government funding does not damage the private character of the program through disproportionate control of the program.

Nonprofit Corporation: NHS programs are incorporated under the 501(c)(3) tax exempt charitable status. No stock or profit accrue to its members.

Locally Controlled: The NHS program is governed by a local board of directors made up of neighborhood residents, at-large community members, private sector representatives, and city government representation or liaison. NHS is not a government controlled program. Neighborhood Reinvestment input is through monitoring and the provision of technical assistance by invitation of the local board of directors.

Designated Neighborhood: The NHS operates in a neighborhood with defined boundaries characterized by (a) a housing stock showing evidence of deterioration and lack of maintenance; (b) an inadequate degree of mortgage and home improvement activities; (c) a substantial degree of homeownership; (d) an income mix in the neighborhood as low as resources will permit (very low family incomes and high repair costs will require raising additional resources for revolving loan funds and staffing); and (e) a neighborhood which, for example, may contain 500-2,000 units. Multiple neighborhoods are encouraged where resources can be raised to adequately staff each neighborhood.

Numerical Majority of Residents on Board: The partnership relationship must be carried out in the board and committee structure. No partner controls, but neighborhood residents constitute a numerical majority of the board. Broad-based community representation may enhance the ability to allow expansion to other neighborhoods. Care should be taken to keep private sector participation substantial enough that a true partnership is in effect. Local government participation is by board membership and/or meaningful committee participation.

Working Board: The NHS board manages the affairs of the corporation. It accepts and carries out the ongoing responsibility for keeping in place the resources necessary to operate the NHS program including loan fund and operating budget funding. Other responsibilities include assuring proper financial management, designating target areas, reaching agreements with local government on appropriate code inspection services and public improvements, working with lenders to insure the availability of bankable lending, maintaining a viable partnership including a strong level of organized resident participation, providing effective staffing and designing creative strategies to accomplish particular neighborhood objectives. The board carries out those responsibilities through a committee structure.

Skilled and Committed Staff: NHS programs have operated with as few as three staff members; however where resources have permitted it programs have achieved greater momentum with a staff of four or more The staff, under supervision of an executive director implements activities mandated by the board of directors The staff provides management support to the board of directors in its fund raising efforts and carries out necessary administrative and community relations functions.

Organized Resident Support: Organized resident support is provided by resident board members and by other organized neighborhood groups to stimulate strong resident participation in the program and create a positive improvement climate within the neighborhood.

Offices in the Neighborhoods: The NHS program is administered from offices in the designated neighborhoods.

Through a cooperative effort the staff, board and committees assure that the neighborhood residents receive the following services

Financial Services Financial counseling is offered with regard to a client's financial alternatives and referrals to financial institutions or other NHS loan resources as appropriate.

Bankable Lending: Financial institutions cooperate to provide mortgage and home improvement loans based upon sound underwriting criteria.

Revolving Loan Fund: NHS administers a loan fund to meet the needs of nonbankable NHS clients and to stimulate improvements which will promote neighborhood confidence. Loans are made at rates and terms which fit the borrower's ability to pay, with the loan secured by the property, usually a second deed of trust or mortgage. NHS counsels with clients to solve payment difficulties. The loan fund is promoted as a self-help tool for the neighborhood and is a private source of loans, not grants, which are to be paid back to provide a continuing resource to the neighborhood(s).

Rehabilitation Counseling: NHS provides analyses of home repair needs, design assistance, cost estimates, work write-ups (specifications), and home repair counseling in relation to owner desires and code deficiencies.

Construction Monitoring: NHS provides on-site inspections of work in progress for NHS loan fund clients, and as a service to NHS clients financing repairs through other resources. NHS serves as a communication link between contractors and residents.

Code Inspections: A sensitive, systematic and comprehensive housing inspection program is key to program effectiveness. The inspections are aimed at achieving voluntary compliance with generally accepted health and safety standards, but are backed-up with local legal authority. In order to implement this strongly recommended program component a city designates specific inspectors to work with the NHS.

Advocacy for Neighborhood Improvement: NHS concentrates on improving the quality of life for neighborhood residents. It is not merely a lending program. NHSs secure public and private resources for capital improvements and improving vacant dwelling units, commercial and multi-family structures, etc. The board of directors continuously evalutes NHS progress towards stabilizing the neighborhood, and may add new program components or expand services to additional areas. Normally, NHS will continue to provide some minimal level of services to the original neighborhood(s).

Neighborhood Reinvestment: The role of Neighborhood Reinvestment is to develop the partnership which forms the heart of the NHS. To maintain the strength and vitality of the program, Neighborhood Reinvestment offers a variety of services including on-site workshops and educational programs, specialized training programs for new NHS staff, educational conferences for NHS boards of directors and staffs, and technical assistance.

THE DEVELOPMENTAL PROCESS

Bringing an NHS program into existence involves creating a working partnership among disparate groups -- groups which, before the NHS developmental process, more often than not exhibit some degree of hostility or lack of confidence in one another. Establishing positive relationships among business people, representatives of local government and neighborhood residents is the central thrust of the developmental process. The men and women on the program development staff of the Corporation are trained in educational processes designed to "build bridges" between the partnership groups, enabling the three groups to discover the common ground on which each of their self-interests will be served and to provide them with the necessary information and understanding to develop an NHS program tailored to the needs of their local community.

The developmental process necessary to establish a new NHS usually takes between 9 and 12 months. The process begins with an application or expression of interest from a city government, a community group, a local financial institution, etc. In response to that inquiry, Neighborhood Reinvestment staff visit the city in order to assess the willingness of potential members of the partnership to commit their energies to the program.

Once Neighborhood Reinvestment staff are convinced that the potential commitments exist for the formation of an NHS, a field representative is assigned and a local coordinator is hired. The local coordinator, someone who is already familiar with the community, works with members of the potential partnership groups in preparation for a carefully designed set of workshops and committee tasks in which local participants develop working relationships and an important sense of joint authorship of the NHS.

The first workshop brings together business and financial leaders, city officials, and community leaders to learn in depth about NHS and commit themselves to establishing a program. An affirmative decision involves the following commitments:

- All partners agree to serve on committees for the remainder of the developmental process and to actively participate in the affairs of the NHS once established.

- Business and financial leaders agree to make financial contributions in support of the NHS operating budget. Financial leaders agree to make home improvement and purchase loans to qualified NHS residents.

- Local government officials agree to make capital improvements and code inspections in the target neighborhood, cooperating with residents in identifying needs. Officials also commit to provide capital for a high risk revolving loan fund for unbankable residents. In smaller communities with limited financial institution bases, the local government also may provide part of the NHS operating budget.

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- Residents agree to actively participate in the program by improving their homes and neighborhoods in cooperation with the other two partners.

The remaining workshops involve selecting a target neighborhood, involving significant resident representation from the selected neighborhood, witnessing an operational NHS in another city, adopting by-laws for the new corporation, and electing a board of directors. The developmental process culminates with the hiring of staff and initiation of operations in the NHS neighborhood.

Although Neighborhood Reinvestment's formal role ends when program operations begin, training and technical assistance are provided to the board and staff upon request. Other types of support, including the provision of interim directors during transition periods, are also provided.

DEMOGRAPHIC PROFILE OF NHS NEIGHBORHOODS

DATE: 2/23/1992
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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY		% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
ABERDEEN	NORTH & SOUTH ABERDEEN	1,898	2%	O	%	$8,322	722	%	$13,445
ALBUQUERQUE	DOWNTOWN	6,000	70%	H	21%	$5,653	1,500	50%	$10,545
ALLENTOWN	OLD ALLENTOWN PRES AREA	5,000	8%	B	21%	$7,734	1,700	69%	$8,800
ANCHORAGE	SPENARD	5,702	18%	B O	2%	$35,763	3,525	44%	$24,100
ATLANTA	GRANT PARK	8,500	45%	B O	15%	$6,735	4,088	53%	$10,545
AURORA	N.E. AURORA & OAK PARK	13,578	35%	BH	11%	$8,837	3,215	86%	$16,350
BALTIMORE	GOVANS-PEN LUCY	12,547	83%	B	20%	$7,560	2,562	80%	$7,000
BALTIMORE	PATTERSON PARK	18,000	10%	B	20%	$8,083	5,000	50%	$7,000
BARBERTON	VAN HYNING	457	1%	B	19%	$7,113	1,075	61%	$21,500
BARBERTON	BARBERTON II	1,850	8%	B	25%	$10,300	850	50%	$25,000
BEAUMONT	BEAUMONT	6,311	7%	BH	%	$19,947	1,296	60%	$25,000
BELOIT	MERRILL	2,800	55%	B	25%	$12,400	725	63%	$20,000
BIRMINGHAM	BUSH HILLS	3,000	52%	B	5%	$16,015	2,511	39%	$25,000
BOSTON	MISSION HILL	16,020	15%	B	15%	$7,397	4,995	33%	$15,370
BOSTON	COLUMBIA-SAVIN HILL	26,363	13%	B	20%	$8,585	8,020	87%	$14,285
BRIDGEPORT	UPPER EAST SIDE	13,301	33%	BHO	13%	$6,837	5,258	87%	$10,400
BRIDGEPORT	SOUTH END	10,000	50%	BH	4%	$5,903	659	63%	$18,000
BUFFALO	BROADWAY-FILLMORE	6,275	25%	B	38%	$11,400	2,735	46%	$8,050
BUFFALO	MASTEN	15,673	98%	B	9%	$12,000	4,958	41%	$10,850
BUFFALO	BLACK ROCK-RIVERSIDE	18,700	1%	B	13%	$8,500	4,000	85%	$15,750
BUFFALO	KEN BAILEY/DELAVAN	7,110	33%	B	16%	$10,398	6,818	60%	$13,335
BUFFALO	SOUTH BUFFALO	11,683	1%	B	10%	$13,300	4,060	58%	$13,150

DEMOGRAPHIC PROFILE OF NHS NEIGHBORHOODS

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY	% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
BUFFALO	WEST SIDE	8,565	5% B	12%	$7,204	2,590	88%	$10,450
BURTON	BENDLE	4,097	2% H	30%	$14,858	2,500	76%	$20,000
CASPER	EAST NEIGHBORHOOD	4,500	1% B	%		1,500	70%	
CHARLESTON SC	GADREN GREEN	4,077	98% B	9%	$5,411	814	57%	$11,700
CHARLESTON WVA	LOWER WESTSIDE	4,558	40% B	28%	$7,235	1,918	46%	$10,000
CHARLOTTE	PLAZA-MIDWOOD	3,040	18% B	16%	$11,800	1,078	83%	$11,800
CHATTANOOGA	GLENWOOD	4,000	75% B	8%	$7,244	1,228	83%	$14,000
CHELSEA	BELLINGHAM/SHURTLEFF	12,000	40% BH	45%	$12,400	793	71%	$8,000
CHELSEA	CHELSEA	2,000	5% H	14%	$8,982	853	60%	$13,600
CHEYENNE	SOUTHSIDE	2,400	45% H	80%		982	63%	$32,000
CHICAGO	WEST HUMBOLDT	27,000	72% BHO	20%	$11,000	5,152	85%	$34,000
CHICAGO	WEST ENGLEWOOD	18,000	95% B	10%	$7,500	3,000	85%	$14,200
CHICAGO	NEAR NORTHWEST	20,820	41% BHO	10%	$8,390	5,554	30%	$12,980
CHICAGO	HEART OF CHICAGO	23,000	40% H	17%	$9,000	3,000	75%	$11,525
CHICAGO	LITTLE VILLAGE	25,000	75% H	9%	$8,691	5,000	85%	$14,400
CHICAGO	CENTRAL AUSTIN	18,000	90% B	25%	$10,318	6,882	92%	$16,025
CINCINNATI	CARTHAGE	2,782	8% B	18%	$15,677	1,223	54%	$28,439
CINCINNATI	EVANSTON	13,327	89% B	28%	$8,170	5,104	58%	$14,075
CINCINNATI	MADISONVILLE	13,734	45% B	24%	$8,872	4,998	55%	$13,810
CLEARWATER	SOUTH GREENWOOD	3,000	14% B	30%	$14,000	1,048	80%	$12,350
CLEVELAND	BUCKEYE	12,000	70% B	15%	$8,100	4,532	45%	$18,000
CLEVELAND	NEAR WEST SIDE	9,806	35% HO	7%	$10,304	3,000	84%	$11,530
COLORADO SPRINGS	VERMIJO-CUCHARRAS	2,243	18% H	9%	[illegible]	701	60%	$8,000

DEMOGRAPHIC PROFILE OF NHS NEIGHBORHOODS

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY	% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
COLUMBUS	LINDEN	10,000	50% B	7%	$10,800	2,545	70%	$18,000
DALLAS	MT AUBURN-SANTA FE-OWENWOOD	7,000	14% B	21%	$7,845	2,384	44%	$10,787
DALLAS	TRINITY HEIGHTS	7,587	97% B	8%	$8,378	2,132	47%	$10,400
DALLAS	NORTH PARK/LOVE FIELD	7,882	77% B	14%	$7,988	2,574	57%	$38,500
DAVENPORT	EAST VILLAGE	3,145	20% B	15%	$15,688	1,703	55%	$22,000
DENVER	HIGHLAND	8,721	70% BH	15%	$10,234	2,708	83%	$25,500
DES MOINES	HARDING	3,500	5% B	35%	$10,500	1,825	81%	$28,000
DETROIT	HIGHLAND PARK	4,800	88% B	5%	$14,000	1,024	49%	$14,300
DURHAM	OLD NORTH DURHAM	3,000	45% B	8%	$9,238	588	50%	$15,000
E PROVIDENCE	RIVERSIDE	6,845	3% B	12%	$8,080	2,100	85%	$14,000
ELGIN	NORTHEAST	14,818	22% BH	8%	$12,855	5,134	43%	$24,000
EMERYVILLE	EMERYVILLE	300	70% B O	25%	$12,140	57	85%	$45,000
EVANSVILLE	MAPLE GROVE (SWEETSER)	542	48% B	13%	$12,140	178	72%	$17,000
FT WORTH	POLYTECHNIC	5,595	60% BH	17%	$7,541	2,288	85%	$15,000
GREAT FALLS	OLD TOWN	5,030	18% O	32%	$9,000	1,250	36%	$30,000
GREEN BAY	WEST SIDE	8,781	2% O	%	$8,500	2,531	83%	
HARTFORD	BLUE HILLS	4,200	83% BH	9%	$8,600	1,200	50%	$20,750
INDIANAPOLIS	BUTLER-TARKINGTON	5,080	80% B	18%	$10,482	2,827	53%	$21,800
INGLEWOOD	LOCKHAVEN	7,712	80% BH	8%	$10,217	2,300	58%	$22,800
ITHACA	SOUTHSIDE	5,350	30% B	%	$0%	2,300	58%	$20,000
JACKSON	WEST JACKSON	1,500	70% B	23%	$14,000	690	80%	
JACKSONVILLE	SPRINGFIELD	2,759	40% B	17%	$3,728	1,018	40%	$7,000
JAMAICA	BAISLEY PARK	7,102	85% B	22%	$10,000	3,303	67%	$29,300

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY		% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
JERSEY CITY	HEIGHTS	43,000	4%	H	%		18,185	31%	
KALAMAZOO	EASTSIDE I	2,981	99%	BHO	%	$14,194	808	46%	
KANSAS CITY KS	PRESCOTT		6%	B	%	93%		55%	
KANSAS CITY MO	CENTER CITY/SOUTH HYDE PARK	6,250	36%	B	21%	$7,980	2,858	50%	$12,000
KANSAS CITY MO	49-63 (EASTERN)	4,400	25%	B	30%	$9,530	1,850	80%	$12,700
KNOXVILLE	PARK CITY	3,247	49%	B	18%	$5,052	1,445	45%	$8,500
LA HABRA	LA HABRA	5,183	40%	H	13%	69%	2,042	44%	$19,600
LAKELAND	DIXIELAND	1,000	2%	H	%	$10,278	880	51%	
LAWRENCE	ARLINGTON	10,000	80%	H	10%	$10,011	2,400	73%	$20,000
LITTLE ROCK	CENTRAL LITTLE ROCK	8,000	55%	B	17%	$6,500	2,000	50%	$12,700
LOUISVILLE	SHAWNEE	4,000	80%	B	9%	$7,906	2,300	88%	$12,100
MACON	MONTPELIER	5,304	80%	B	10%	$5,879	1,788	40%	$25,000
MENLO PARK	BELLEHAVEN	4,858	98%	BH	%	$7,656	1,348	54%	
MIAMI	WEST LITTLE RIVER	7,855	85%	B	6%	$11,300	2,098	57%	$15,523
MILWAUKEE	SOUTHSIDE	10,407	35%	H	11%	$7,844	3,514	45%	$10,075
MILWAUKEE	NORTH SIDE	12,228	90%	B	10%	$7,700	3,624	54%	$10,067
MINNEAPOLIS	NORTHSIDE - WILLARD/HOMEWOOD	7,578	50%	B	%	$9,500	2,250	74%	$40,000
MINNEAPOLIS	REGINA	2,000	60%	B	%	$9,000	948	87%	$17,100
MINNEAPOLIS	SOUTHSIDE	6,386	52%	B O	14%	$8,000	3,625	72%	$42,000
NASHVILLE	WAVERLY-BELMONT-HILLSBORO	3,485	65%	B	11%	$8,210	1,190	37%	$14,300
NASHVILLE	INGLEWOOD	5,453	70%	B	8%	$11,500	1,840	58%	$11,100
NEW BRITAIN	BROAD AND NEWBRITE	12,708	55%	BH	8%	$9,500	4,181	83%	$33,000
NEW HAVEN	UPPER STATE, DWIGHT/EDGEWOOD	13,033	12%	BH	21%	$8,200	3,700	57%	$30,000

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY		% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
NEW ORLEANS	BROADMOOR	7,487	80%	B	15%	$15,328	1,471	34%	$35,000
NEW YORK	KENSINGTON/WINDSOR (BROOKLYN)	41,344	23%	BHO	%	$10,836	4,105	87%	
NEW YORK	WILLIAMSBRIDGE (BRONX)	37,388	48%	B	%	$10,648	5,498	%	
NEW YORK	SOUNDVIEW (BRONX)	55,351	73%	B O	%	$10,527	2,697	50%	
NEW YORK	LAURELTON (QUEENS)	14,817	88%	B	%	$12,519	5,131	77%	
NEW YORK	EAST FLATBUSH (BROOKLYN)	44,000	79%	BHO	%	$11,485	5,752	50%	
NEW YORK	WEST BRIGHTON (STATEN ISLAND)	21,280	28%	BHO	%	$11,430	2,537	58%	
NEWARK	WEEQUAHIC PARK	17,928	93%	B	14%	$8,088	6,488	51%	$20,075
NIAGARA FALLS	AREA 4	8,000	12%	B	30%	$8,548	2,557	61%	$13,250
NORWALK	SOUTH NORWALK	6,812	50%	BH	%	$12,507	1,004	54%	$25,000
OAKLAND	ELMHURST	16,328	85%	B	17%	$6,183	8,500	35%	$18,125
OKLAHOMA CITY	CAPITAL HILL	7,753	26%	BHO	35%	$12,887	1,218	58%	$28,500
ORLANDO	DELANEY	3,000	8%	B	40%	$11,500	1,000	75%	
PASADENA	N W PASADENA	5,838	88%	B O	8%	$7,935	2,300	68%	$17,034
PEORIA	WEST BLUFF	8,855	3%	B	10%	$14,300	3,319	68%	$16,700
PHILADELPHIA	EAST FRANKFORD	12,018	21%	B	27%	$8,523	5,510	58%	$7,858
PHILADELPHIA	ALLEGHENY WEST	13,130	85%	B	13%	$7,768	3,520	71%	$8,748
PHOENIX	PHOENIX II	8,831	25%	BH	%	$6,838	2,774	40%	$11,000
PHOENIX	PHOENIX	5,000	13%	B	18%	$8,221	1,887	57%	$12,200
PITTSBURGH	CENTRAL NORTHSIDE	7,303	50%	B	32%	$5,830	656	27%	$7,010
PONTIAC	PONTIAC	3,000	87%	B	7%	$13,430	1,501	71%	$25,000
PROVIDENCE	ELMWOOD	14,456	40%	BH	20%	$8,800	3,500	74%	$12,000
PUEBLO	MINNEQUA HEIGHTS	4,213	33%	H	8%	$8,000	1,857	78%	$19,000

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY		% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
PUEBLO	EAST SIDE	3,758	48%	BH	26%	$14,843	2,283	73%	$10,200
QUINCY	SOUTHWEST	8,580	1%	B	15%	$10,524	2,860	42%	$35,000
READING	WARD 8	2,603	80%	BH	10%	$5,700	845	63%	$8,400
RICHMOND VA	NORTHSIDE	3,888	99%	B	14%	$9,038	920	74%	$14,900
RICHMOND, CA	S-SIDE:CORTEX,CORONADO,SANTAFE	5,840	98%	BH	%	$6,539	2,044	50%	$17,100
ROCHESTER	BROWN SQUARE/EDGERTON	11,000	5%	B	12%	$10,000	4,318	44%	$12,733
SAGINAW	CENTRAL EAST	11,589	50%	B	11%	$7,798	4,003	49%	$11,100
SALT LAKE CITY	FAR WEST		35%	B	%		3,000	%	
SALT LAKE CITY	CENTRAL EAST	3,700	1%	B	15%	$8,729	3,268	88%	$14,900
SALT LAKE CITY	WEST SIDE	9,123	33%	H	%			65%	
SAN ANTONIO	WEST SIDE	10,700	98%	H	17%	$4,308	2,914	41%	$7,100
SAN BERNARDINO	CT 47-48	8,700	100%	BH	9%	$6,215	2,300	58%	$10,500
SANTA ANA	ARTESIA/PILAR	3,873	74%	HO	5%	$12,580	1,259	72%	$18,900
SAVANNAH	BALDWIN PARK	2,349	60%	B	18%	$10,241	1,041	57%	$10,000
SCRANTON	HILL SECTION	4,600	5%	B	25%	$10,000	1,344	50%	$35,000
SHREVEPORT	QUEENSBOROUGH	3,000	90%	B	17%	$7,798	1,000	63%	$28,800
SOUTH BEND	NEAR NORTHWEST	5,922	12%	BH	22%	$10,000	3,884	55%	$10,500
SOUTH PORTLAND	FERRY VILLAGE	2,500	%		0%	$8,130	769	66%	$11,200
SPRINGFIELD MA	UPPER HILL	10,000	70%	B	15%	$8,819	2,525	80%	$22,000
SPRINGFIELD OH	SOUTH CENTRAL	3,880	55%	B	14%	$8,000	2,034	58%	$10,500
ST LOUIS	PEN ROSE-O'FALLON	21,784	98%	B	10%	$13,640	6,700	53%	$13,800
ST LOUIS	SOULARD	7,300	2%	B	15%	$7,142	2,413	55%	$7,000
ST LOUIS	BENTON PARK	11,085	98%	B	11%	$8,670	[illegible]	19%	$7,210

DEMOGRAPHIC PROFILE OF NHS NEIGHBORHOODS

CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY	% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MEDIAN VALUE
ST PAUL	WEST SIDE	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
ST PAUL	MERRIAM PARK	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
ST PAUL	DAYTON'S BLUFF	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
ST PETERSBURG	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
STAMFORD	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
SYRACUSE	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TACOMA	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TAMPA	HYDE PARK	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TAMPA	TAMPA HEIGHTS	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	
TOLEDO	OLD WEST END	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TOLEDO	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TRENTON	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TUCSON	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TULSA	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
UNION COUNTY	RAHWAY	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
UNION COUNTY	ROSELLE	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
UNION COUNTY	LINDEN	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
UTICA	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
VALLEJO	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
WASHINGTON DC	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
WASHINGTON DC	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
WATERBURY	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

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CITY NAME	NEIGHBORHOOD NAME	POPULATION	% MINORITY	% OVER 65	MEDIAN INCOME	# UNITS	% OWNER OCCUPIED	MED VALUE SINGLE FAMILY
WEST PALM BEACH	GARDEN DISTRICT	3,500	50% BH	11%	$8,302	2,658	85%	$30,258
WILMINGTON	THE BOTTOMS	3,385	98% B	28%	$4,700	881	60%	$7,000

NEIGHBORHOOD SUPPORT, TRAINING AND TECHNICAL ASSISTANCE

Program Goal

The program goal of Neighborhood Support, Training and Technical Assistance is to provide services to local NHS programs to help them become operational and to ensure their continued viability and effectiveness.

Methods of Achievement

These program goals are accomplished by providing formal training programs, on-site training, educational conferences, technical assistance, neighborhood strategy assistance, fund raising assistance, and grants to support capitalization and operating expenses of a secondary market for low interest NHS loans operated by Neighborhood Housing Services of America (NHSA). These activities are described below:

Training Programs -- Neighborhood Reinvestment's NHS training department offers several intensive courses for new and prospective NHS staff members to insure high quality, comprehensive training in organizing, managing and providing technical services to NHS neighborhoods.

Executive Director's Training Program -- an extensive introduction for new executive directors to the operation of an NHS. This two-week course provides new executive directors with the wide range of skills and knowledge needed to manage a local nonprofit corporation. The course provides participants with a grounding in the philosophy and goals of NHS, leadership development, service delivery principles for voluntary organizations, and in day-to-day administrative skills. It also provides a general examination of the technical skills affecting an NHS: revolving loan fund principles, appraisals and loan underwriting, conventional lending principles, contract monitoring, and housing rehabilitation techniques.

Rehab Specialist's Training Program -- (also referred to as Construction Specialist) is an extensive introduction to the organization and management of the construction components of an NHS program. Geared to meet the specific needs of new NHS rehabilitation/construction specialists, the program includes working sessions on building inspections, specification writing, cost estimating, contractor supervision and work payments, and client/contractor relationships. Electrical, plumbing and heating theories and techniques are also discussed in detail. Since the Rehab Specialist Training Program began in early 1980, five training programs have been conducted for 100 local NHS Rehab staff members.

Rehabilitation Specialist's Internship Program -- established to ensure that a pool of trained applicants would be available to NHS programs around the country. This comprehensive three month course provides two weeks of administrative training and six weeks of classroom technical training in such subjects as specification writing, carpentry, electrical work, and cost estimating. The participants, who usually have a background in construction, are then assigned for a full month to an operating NHS where they work under the close supervision of an experienced rehabilitation specialist.

On-Site Training -- Neighborhood Reinvestment's field staff provides a variety of on-site training and technical assistance, tailored to meet the individual needs of each program. This assistance includes:

NHS Executive Director Orientation -- designed to provide a new director with a general overview of NHS operations, and a recommendation for an individually-tailored self-education program which may include an internship in a savings and loan, a bank, or the city's code department. The orientation also assists the director in getting local operations underway and in acquiring job descriptions and other administrative materials developed by other NHS programs.

Board of Directors Workshops -- field staff also helps the boards of newly-formed programs plan and conduct a workshop to formulate their committee structures, establish goals, and define the roles of board members and staff. Established boards may request a workshop as a structured forum in which to review their progress, set new goals using management-by-objectives techniques, or draw upon the experience of other programs to overcome a particular problem.

Local Educational Workshops -- as needed, members of the NHS partnership request assistance in conducting special workshops to increase the involvement of local institutions which provide appraisals, loan underwriting, real estate services, construction or mortgage insurance. These workshops are particularly intended to explain the NHS program's goals and accomplishments to individuals who make daily decisions affecting the NHS residents.

Educational Leadership Conferences -- the support activities provided by Neighborhood Reinvestment have developed in response to the needs of the NHS programs themselves. These activities sometimes take the form of regional or national conferences at which NHS participants can share information and learn from the experience of other programs.

Leadership Conferences -- allow representatives of the partnership groups from around the country to address the needs of the context of today's economic and governmental climates. The conference program focuses on the most pressing issues facing NHSs including financial support, program expansion and the role of NHS in the community after its initial goals have been met. The conferences provide a forum in which board members, NHS staff and Neighborhood Reinvestment staff can exchange information on solutions they have developed.

Regional NHS Conferences -- planned by committees of NHS partnership members, the four regional conferences bring together representatives of the NHS partnerships in each of the four regions of the country for a series of workshops and seminars. The conferences provide both formal and informal settings in which NHS participants can share their experiences and knowledge with others working for similar goals.

Residents' Workshops -- four regional workshops provide representative neighborhood residents the opportunity to share their experiences and discuss ways in which residents can maintain an effective role in the NHS partnership. Formal sessions are held on specific regional concerns: displacement, code enforcement, leadership skills, etc.

Technical Assistance -- occasionally, local circumstances such as the loss of a staff member or limited financial resources threaten the momentum of an NHS. When this occurs, the NHS may request technical assistance from Neighborhood Reinvestment. That assistance may come in many forms, ranging from assisting with bookkeeping or housing rehabilitation problems to conducting workshops on the operation of loan committees or providing a temporary executive director. By design, an NHS is an autonomous local private corporation. Although every NHS has the same basic focus on neighborhood revitalization, each program's partnership board has a unique composition, and thus has different strengths and weaknesses. This is equally true of the staff at each NHS. Because no two neighborhoods are the same, each NHS also faces somewhat different problems. To provide the range of technical assistance needed, without affecting the program's autonomy, requires a sensitive and highly flexible response from Neighborhood Reinvestment field staff.

Secondary Market Support -- a significant element leading to the success of NHS programs is their continued ability to provide low interest loans for home improvements to homeowners who are unable to obtain financing through conventional means. This assistance is provided through a revolving loan fund. This loan fund is initially capitalized through a direct grant from Neighborhood Reinvestment to a new NHS, and by grants from the local government and from financial institution partners to the NHS. This loan fund has become particularly important in the high interest environment in which NHSs must now operate.

Because much of the revolving loan money is lent on a long-term basis, the revolving funds would soon be exhausted were there not a secondary market for the loans. This secondary market is provided through the financial operations of Neighborhood Housing Services of America (NHSA). Neighborhood Reinvestment in its support function provides capital to NHSA to purchase loans from NHSs. NHSA, in turn, markets the loans to private investment funds. (For a more detailed description of the operations of NHSA's secondary market, please see Appendix M.)

Fund Raising Assistance -- the rapid escalation of construction costs has strained the capacity of individual local NHS revolving loan funds and has, in turn, intensified demand in the secondary market (which NHSA administers) for NHS revolving loan fund loans. In addition, at current interest rate levels, NHS homeowners traditionally considered bankable are postponing work -- reducing program momentum and the resultant reinvestment psychology which causes a neighborhood to "take off" through private initiative.

At the same time, there is a great deal of demand for NHS programs to expand into additional neighborhoods, and specific neighborhood needs require the use of additional programmatic tools in many neighborhoods. In order for NHS to pursue these expansions, both programmatic and geographic, additional operating funds are required for each local NHS program undertaking them. Traditionally NHS operating budgets have been contributed primarily by local financial institutions; however, the current difficult economic conditions for thrift institutions are affecting the ability of NHS programs to raise funds from this source. In addition, remaining sources of Federal assistance are subject to intensified local competition. As a result, a broader base of corporate support will be required in most communities in order for NHS programs to maintain their services and undertake programmatic and geographic expansions.

Development of financial resources for NHS is a shared responsibility between Neighborhood Reinvestment and NHSA. NHSA has retained the firm of Marts & Lundy, Inc. as fund raising counsel and with their assistance, we have devised a three track effort to provide assistance to the NHSs in this area. (Please see Appendix M for more detail.)

Neighborhood Strategies -- with the help of the Ford Foundation, we are now able to offer a new form of assistance to NHS programs which we are calling Neighborhood Strategies. Neighborhood Strategies involve helping the NHS board and neighborhood residents, block-by-block, visualize what it means to complete work in their neighborhood. This is a refinement on our earlier goal of "turning around" a neighborhood, where our emphasis had been on changing the direction from decline to improvement. Today, as more and more neighborhoods are reaching the point of needing to decide just when the NHS will have achieved its goals, and there is growing demand for NHS to serve additional neighborhoods, a finer tuning of what "completion" means is required. Through work with individual NHS programs, and all of them at recent regional conferences, we have been able to assist NHSs in focusing on this concept and begin setting specific attainable goals for completion in neighborhoods and sub-neighborhoods.

Impact

It would be difficult to separate the impact of [illegible] Program Support, Training and Technical Assistance from that of [illegible] in general. Since each [illegible] program can continue year after year to produce more than a million dollars in benefits in excess of support costs, the investment in maintaining the health and viability of existing [illegible] programs is well worthwhile.

APARTMENT IMPROVEMENT PROGRAM

Program Goal

The goal of the Apartment Improvement Program (AIP) is to bring privately owned, conventionally financed apartment buildings, which are in trouble financially and physically, back into viable operation so that these buildings provide a return for the investors as well as a decent living environment for the tenants.

Methods of Achievement

The Apartment Improvement Program is based upon a partnership of property owners and managers, tenants, financial institutions and the city. Through the use of the computerized Real Estate Investment Analysis Model a financial analysis of the current and projected operations of each building is studied. This model aids in the development of an individually tailored improvement plan through which each building may benefit from such activities as tenant participation, contemporary tax assessment methods, and increased investment or restructured mortgages to improve the economic viability of the buildings and to finance improvements. Developed in Yonkers, New York, the Apartment Improvement Program in its first 16 months was able to "turn around" sixty-five apartment buildings containing 3,500 units.

Each of the above partners has a significant role to play in the apartment improvement process:

- The city provides diagnostic building inspection and code enforcement; condemnation and demolition of selected buildings if appropriate; counseling assistance to existing and future tenants including Section 8 assistance if appropriate; public improvements and amenities; use of assessment and tax deferral programs; and in many programs, implementation of the computerized investment analysis program, and administration of the program.

- The tenants and advisory groups serve on advisory committees that help define and plan improvements needed in buildings; develop and/or support creation of tenant organizations for ongoing communication with owners and managers; screen potential tenants; provide input regarding rent levels; and help maintain building standards.

- The building owners and managers accept involvement of tenants and city officials in building analysis, make available all cash statements and financial information, and respond positively to the need for improvements. Owners and managers are asked to cooperate in making needed improvements while following a financial plan which keeps rent prices as low as possible. In some cases, a change in management and/or ownership is required.

o The mortgagee(s) provides staff to become involved in building analysis and to meet with the other partners; considers restructuring the mortgage; uses the "good repair" clause or other legal means to encourage the improvement of buildings where owners are slow in responding; and assists in finding and/or financing new owners.

Accomplishments

AIPs have been established in 11 communities to date. Three of these programs have begun or completed work on a total of 132 apartment buildings. In each case, improvements in the building have been achieved through one or more of the following remedies:

-- restructuring the existing mortgage (amount, time, rate)
-- restructuring of property income and expenses
-- services and financial counseling to existing or new tenants
-- generating a physical improvement program with code requirements as a minimum
-- assessment and tax deferral benefits
-- municipally financed capital improvements
-- restructuring of property ownership and/or management
-- improved tenant counseling
-- improved tenant-landlord communications

Six AIPs are currently in development and four more will be started in FY 1982. Ongoing technical assistance is being provided to the 11 operating Apartment Improvement Programs.

Impact

AIP programs to date have generated a total of approximately $13 million in building improvements. Typically, an AIP will continue to take on additional buildings for improvement as long as the problem of deteriorating multi-family housing to which AIP techniques can be applied exists in the community.

The impact study, Neighborhood Partnerships in Action summarized:*

"The leverage of public resources in the AIP is extensive. To be conservative, private investment in the program will be considered to consist only of the value of improvements to a building. The value of time spent by volunteers on AIP business is not counted here because it is difficult to estimate and varies from year to year. The present value of the subsidy provided by the differences between market and actual mortgage interest rates is not included because, in many cases, lenders do not have the option of getting out from under the building mortgages on terms comparable with those in the conventional market."

* This section of the report was authored by Roger Ahlbrandt, who is currently Urban Policy Advisor to the Assistant Secretary for Policy Development and Research, U.S. Department of Housing and Urban Development.

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"Public investment in the program consists of the direct costs of operating the program and the value of property taxes foregone if tax reductions have been granted. However, taxes foregone are not included as a cost of the program for reasons similar to those discussed above. Many properties that had taxes restructured were either in foreclosure at the time they entered the AIP or were making little or no profit. Tax reductions would have been sought and probably granted for these buildings, and taxes would have been lost to the city anyway.

"In Yonkers, the average building received approximately $200,000 in improvements; the staff estimates that five buildings could be improved per year, which means privately financed annual program improvements would total $1 million. Assuming annual program operating costs of $125,000, each public dollar invested in the program is leveraged eight times. This computation is conservative; it does not take into account the additional private investment that occurs in surrounding properties and neighborhoods as AIP results are observed.

"The leverage obtained in Mount Vernon is even higher. Total public costs (including money spent by Neighborhood Reinvestment and the city) amounted to $28,000, which produced $450,000 worth of private investment in Bailey Gardens. Therefore, each public dollar produced sixteen private dollars.

"In Hartford, annual staffing costs are approximately $40,000. This funding produced $282,000 worth of private investment in the Sigourney Street project, and a leveraging of each public dollar by a factor of seven."

PROBLEM PROPERTIES STRATEGIES

Problem Properties Strategies are designed to assist NHS programs in addressing "Sticking Points" which are beyond the scope of basic NHS services and financial resources. These Problem Properties vary among neighborhoods but frequently involve: vacant or abandoned houses; low percentages of homeownership and a significant number of poorly maintained rental properties, vacant lots; a lack of affordable quality rental housing and small undermaintained buildings. Through the implementation of various problem property strategies, NHS programs with assistance from Neighborhood Reinvestment are able to address these sticking points:

- Assist potential owner-occupants in purchasing and rehabilitating vacant houses or blighted rental property.
- Promote confidence in target blocks as problem properties are treated.
- Improve the physical condition of target blocks.
- Generate and reinforce interest in NHS services by neighborhood residents.
- Stimulate private reinvestment and new conventional mortgages in the NHS community.

Methods of Achievement

The Rehabilitation and Sale Program allows a local NHS to purchase a vacant house, rehabilitate the home fully, and then resell the improved property of a homeowner. In some instances, a modest subsidy from the local government is needed to bring the price of the house down to the neighborhood market value. Purchase and construction financing for the potential buyer are also necessary to make the program successful.

Neighborhood Marketing efforts focus on a neighborhood marketing program to attract new owner-occupants for vacant or abandoned properties which may be too expensive for a neighborhood tenant to purchase and rehabilitate. The approach includes homeownership counseling, rehab assistance and financing alternatives, and may also provide current homeowners with home maintenance training.

Tenant Conversion assists existing neighborhood residents in purchasing the home they presently rent or a nearby home in the NHS neighborhood. A tenant adviser assists families in finding homes to buy within the neighborhood and works with them to solve financing and rehabilitation problems. In city after city, NHS programs have discovered a large pool of stable renters with excellent rent payment records and the ability and desire to become homeowners with the help of NHS counseling and flexible financing. Using this approach, problem properties represented by undermaintained, absentee-owned properties can also be eliminated.

Small Apartments and Residential-Over-Commercial Properties may be problem properties, hampering the NHS's effort in particular blocks. Where NHS neighborhoods have a significant number of small multi-family structures of two to eight units, these properties are sometimes owned by marginal or unsophisticated investors who do not provide adequate maintenance and needed rehabilitation. The same situation exists with residential apartments over neighborhood stores. In both instances, the NHS has intervened to arrange a rehabilitation financing package for the existing or new owner in order to get these highly visible problem properties turned around.

The principle participant groups and operational elements which may be selected for development of a Problem Properties Strategies program include the following:

- Neighborhood Residents agree to serve on committees which direct the program; stimulate the interest of others; identify menacing properties suitable for acquisition, rehabilitation and sale; assist in locating owners of vacant buildings; watch homes during reconstruction to reduce vandalism; market properties to prospective purchasers; encourage neighbors to improve their properties; and work to obtain public improvements in the program area.

- Financial Institution Representatives agree to serve on committees which direct the program; contribute their technical expertise as an equal partner in the program; provide construction and permanent financing; convey institution-held properties to speed their rehabilitation and sale; and assist when appropriate in obtaining necessary insurance.

- Local Government Representatives agree to provide diagnostic housing and building inspections; acquire properties and/or convey government-held dwellings to speed rehabilitation and sale; consider forgiving back taxes to make acquisition feasible; provide public improvements to the target area; consider underwriting partial operating costs for the program; and subsidize capital outlays to ensure sale of homes at neighborhood market values.

- Technical Staff administer the process; carry out the goals of the Problem Properties Strategies program partnership; and manage the program.

- Realtors agree to market vacant properties, coordinating their efforts with lending institutions, the city and the NHS staff.

- NHS Revolving Loan Fund is made available to unbankable clients who wish to purchase and/or rehabilitate previously vacant or rental houses.

Accomplishments

During FY 1981, the development of a Problem Properties Strategies program was completed for one NHS and begun for one other NHS program. To date, Problem Properties Strategies development has been begun for six NHSs and completed for ten NHS programs.*

Impact

NHSs with Problem Properties Strategies which focus on rental conversion to home ownership have converted and rehabilitated an average of 20 to 25 houses per neighborhood with an average total value of about $418,000. Throughout the program, 40 to 75 potential new homeowners are counseled.

NHSs with strategies which focus on rehabilitation and sale of vacant houses have averaged about 6 houses per neighborhood per year with an average per year total value of $180,000. Directly related spin-off reinvestment by residents in target areas is evident but cannot be separated from the overall impact of the NHS.

*Until this year these were known as Home Ownership Promotion and Rehabilitation and Sale programs.

INSURANCE INDUSTRY FULL PARTNERSHIP PROGRAM

Program Goal

The Insurance Industry Full Partnership Program was developed in response to difficulties NHS residents were having in securing voluntary insurance and the impact this was having on the NHSs' ability to rebuild confidence in their neighborhoods. The Insurance Industry Full Partnership Program is designed to strengthen the delivery of voluntary residential insurance services in the neighborhood as well as involve the local insurance industry in the financial and managerial support of the NHS at a level comparable to that of the banks and savings and loans.

Methods of Achievement

Creation of an NHS-Insurance Industry Full Partnership Program entails 9 months of workshop and committee work. This process brings together, usually for the first time, senior company officers, local company underwriters, agents, residents, lenders, city representatives, and NHS staff. For most insurance representatives it is the first time they actually walk through the neighborhood or develop a sense of what happens when a neighborhood begins to turn around. Usually, it is the first time a city code official and an underwriting manager have the opportunity to discuss and recognize the similarity between company underwriting criteria and city code requirements. And for residents, it is the first time they have been given detailed information concerning industry operations, structure, and limitations--which provides an important base for their participation in committee discussions regarding their insurance needs and possibilities for developing new products, marketing strategies, and adaptation of eligibility criteria. Through service on committees, the groups work together to develop specific proposals concerning:

- How the delivery system can be strengthened in order to assure residents access to service by agents;
- The need for additional forms of insurance coverage which would be responsive to residents' needs;
- In light of NHS efforts, the criteria which need to be met in order to be eligible for particular forms of coverage;
- The roles NHS can play in facilitating education/communication among companies, agents, and residents; and
- The level of financial and management support the industry can provide to the NHS's operation.

Based upon the development of this pilot project in Chicago and replication in four additional cities, we have found the basic components of this program to be:

- An in-house NHS Insurance Coordinator who provides outreach, one-on-one counseling to residents, assistance throughout the process of securing coverage through the voluntary market and/or claim settlement and in reducing the need for the Fair Plan in the NHS neighborhood;
- Company communications to their underwriters and agents -- regarding their desire to service NHS neighborhoods;
- A list of agents who are familiar with the neighborhood and want to and are able to provide good service;
- Company liaisons who know the neighborhood and can assist in the placement of insurance should any difficulties arise;
- The availability of a full range of coverages by standard carriers which will respond to the needs of NHS residents;
- Recognition of the similarity between general industry underwriting criteria and city code and that homes which are up to code will in most cases meet industry underwriting criteria;
- Industry representation on the NHS board and committees; and
- Industry participation in the financial support of the NHS at a level comparable to that being provided by the banks and savings and loans.

Impact

In the past two years, as a result of their participation in the creation of NHS Insurance Industry Full Partnership programs, a number of companies have developed and tested new forms of coverage to address the insurance needs of urban homeowners such as properties with a substantial discrepancy between market and replacement values, the sound properties adjacent to a vacant building or vacant properties undergoing substantial rehabilitation. The NHS strategy of coordinated reinvestment block-by-block has provided companies with the environment in which they can test these coverages.

The companies' commitment to NHS is also reflected in financial investments in NHS partnerships in the form of contributions and social investments. Company contributions to NHS Full Partnership programs have totalled over $1.2 million to date.

Industry-wide contributions of over $1 million have enabled the six local Insurance Full Partnership programs to enhance services in their neighborhoods, and special challenge grants from the St. Paul Companies and Allstate have allowed the Twin Cities and Chicago NHSs to expand their programs to additional neighborhoods. Equitable, Prudential and Allstate have also recognized that the NHS neighborhood offers sound investment opportunities and have made significant commitments to NHS through social investments.

OWNER-BUILT HOUSING

Program Goal

The Owner-Built Housing program addresses the severe shortage of afford-able, quality housing facing moderate income families. Based on a rural self-help model, this new program enlarges homeownership opportunity in NHS neighborhoods by families collectively building their own homes, with supervision, coordination and technical assistance provided by the NHS. The initial demonstration project in the NHS neighborhood in Oakland, California was developed in 1980. It consists of 14 families who invested 40 hours of work per week per family for a period of nearly a year. This investment has enabled each family to take title to a conventionally financed home with an estimated market value of over $80,000 by assuming a $40,000 mortgage.

Methods of Achievement

The program was designed and has been implemented by the NHS in Oakland, California. The program progressed in the following manner:

: Development Phase -- The NHS purchases contiguous lots from the city at a reduced cost, receives commitments from lenders to assist in financing the construction and prepares house plans.

: Pre-Construction Phase -- The NHS markets the program and selects participants based on income limits. Participants are organized into family associations and provided construction training by the NHS. Lenders assist in qualifying participants for loans.

: Construction Phase -- The NHS provides construction supervision and inspection services to groups of families as they cooperatively build each of the 14 houses.

: Loan Closing -- The NHS assists in closing the construction loans and the families are able to occupy their homes.

Accomplishments

This vehicle for providing single family homes for about half of market value is being replicated in Santa Ana, California, Salt Lake City, Utah and Hartford, Connecticut, and expanded to eight additional owner-built houses in Oakland.

Impact

The following table summarizes the direct impact of the Oakland NHS's Owner-Built Housing program:

Owner-Built Housing Fourteen Home Development	Per Unit	Total
Land and Improvements	$ 6,000	$ 84,000
Construction	33,000	462,000
Financing	7,000	98,000
TOTAL	$ 46,000	$644,000
Estimated Market Value	$ 80,000	$1,120,000
Savings to Owner-Builders*	$ 34,000	$476,000

*Equals Family Labor Equity Earned

Administrative Costs (covered by Neighborhood Reinvestment Grant)	$100,000

Administrative costs in future Oakland Owner-Built developments are expected to be approximately 50% lower than in the pilot project. The leverage on Neighborhood Reinvestment's start-up assistance will continue to grow as future development is totally funded by local resources.

ENERGY CONSERVATION

Program Goals

The goals of the energy conservation program are to create model neighborhood energy conservation strategies which can then be replicated in other NHS and all neighborhoods.

Neighborhood Reinvestment has been working with several NHSs across the country in developing comprehensive and effective energy conservation programs to combat rising fuel and utility costs. With assistance from the [illegible] Foundation, the strategies developed, materials produced, and experience gained from the most promising models are being incorporated into "composite" models. These model strategies will be tested and refined this year through their replication in three NHS neighborhoods and two Apartment Improvement Programs.

Neighborhood Reinvestment is also increasing the quality and quantity of energy conservation training in the [illegible]-based Rehabilitation [illegible] Training Program in order to assure that energy conservation improvements are integrated into the rehabilitation and counseling services offered by the local NHSs. In addition, Neighborhood Reinvestment is now publishing a manual on energy conservation techniques and strategies to be utilized in rehabilitation by NHS and AIP programs.

Methods of Achievement

Neighborhood Reinvestment funded three programmatic approaches toward delivering energy conservation services to NHS residents:

- Elmwood NHS Energy Conservation Program (Providence, Rhode Island) The Providence Elmwood NHS is developing an energy conservation program that provides a comprehensive energy audit program and educational outreach. The energy audit will: (1) evaluate the effects of physical problems on energy consumption; (2) determine the effects of living patterns and habits on energy consumption, and (3) analyze energy costs related to a building's cash flow. The educational outreach includes seminars, workshops, and working models demonstrating how various energy conservation measures can actually be used.

- Ferry Village NHS Energy Conservation Program (South Portland, Maine) Ferry Village NHS is systematically integrating energy conservation audit and repair procedures into its operations. Energy conservation is being tested as an alternative to sensitive code enforcement in the marketing of the NHS's comprehensive rehabilitation services. In-home discussions and workshops for small groups of residents also demonstrate cost-effective do-it-yourself energy conservation techniques.

- o Salt Lake City NHS Energy Conservation Program (Salt Lake City, Utah) Salt Lake City NHS is coordinating the full spectrum of existing energy conservation resources for its neighborhood. Partners with the NHS in this effort include: city and state governments, utility companies, schools, lending institutions, contractor trade associations, and community action programs. The comprehensive plan evolved in the NHS neighborhood will serve as a model for other neighborhoods in the city.

Based upon the success of these efforts, Neighborhood Reinvestment was recently awarded an energy conservation grant by the Ford Foundation to allow for an expansion of energy conservation efforts among NHS and AIP programs. The grant is helping to support energy conservation efforts by three NHSs and two AIPs as well as training programs at Neighborhood Reinvestment's Training Department. In addition, the grant is contributing to the publication of Weathervane.

The NHS programs are in Chelsea, Massachusetts, Denver, Colorado and Rochester, New York. In Chelsea, the NHS staff is working with property owners, managers and renters in developing a model approach to integrate weatherization into both the rehabilitation and management of two-to-six flat buildings.

In Denver, the Highland NHS is undertaking a comprehensive weatherization project which focuses on training volunteer residents, predominantly senior citizens, as energy auditors. The residents will help market the program, do audits and informally assist homeowners as they complete their energy conservation rehab.

In Rochester, two NHS rehab specialists are being trained as energy auditors by the Rochester Gas and Electric Corporation. After training, they will develop a plan to incorporate energy conservation into many aspects of the NHS rehab process. The NHS is also organizing an energy conservation committee with strong representation from utilities and various energy conservation groups.

AIP programs sharing in the Ford grant funds are in New York City's Northwest Bronx and Pehlam Parkway areas. Projects in these two programs are seeking to integrate conservation techniques and materials into the rehabilitation and management of large buildings. Through AIP, New York City's rehab staff is being helped to place more emphasis on energy conservation in work write-ups. Presently, the first rehab packages are being reviewed with lenders.

Neighborhood Reinvestment's Training Department is using some of the Ford funds to establish model curricula and training in energy conservation for NHS executive directors and rehab specialists. The training for executive directors includes methods of increasing outreach services to the community, and the use of energy conservation as both a marketing tool for NHS programs and as a way of attracting other resources, such as utilities, to the partnership. The training for rehab specialists spans the need for energy conservation, the basics of technology and up-to-date product information, the cost effectiveness of low-cost and no-cost weatherization, and the conservation specialist's role as a community educator.

NEIGHBORHOOD BUSINESS CENTERS

Program Goal

This program is designed to assure the viability of commercial districts by strengthening small businesses, improving the physical environment of the area and providing additional goods, services and employment for the community. Each Neighborhood Business Center is a locally controlled partnership of merchants, commercial property owners, residents, lenders and city officials and is intended to complement the work of NHS programs.

Methods of Achievement

Neighborhood Reinvestment has studied nine neighborhood commercial revitalization projects to draw out the best "selected" model from all of them and has worked intensively with groups in four cities -- Baltimore, Chicago, Philadelphia, and Portland, Oregon -- to fine tune the model for dealing with the complex problems facing neighborhood business districts. The model is based on a partnership approach, following the successful partnership process of the NHS program. This approach is based on the conviction that the residents, merchants, property owners, government and lenders who do business in an area all share an interest in seeing the area remain a vital community asset. Key elements of the model are:

The Neighborhood Business and Property Owners -- In order to effect change in a business district, the merchants and property owners must be willing to:

- develop a Neighborhood Business Center organization
- reinvest in their own businesses and properties
- plan and implement a joint advertising and promotion campaign
- establish design standards
- develop a long-range physical plan for the district
- establish a special assessment district

Community Representatives -- In defining needed improvements, community representatives must be willing to:

- develop and support a Neighborhood Business Center organization
- provide input on merchandising, advertising and promotion
- identify needed public improvements

Financial Institutions and Other Business Leaders -- Representatives of financial institutions and other businesses contribute their time to serve on committees, offering their business judgement for the benefit of the program. Representatives of financial institutions become involved in individual business activity and also:

- restructure mortgages where necessary
- serve on a loan committee
- assist in identifying and/or financing new businesses
- help raise operating and revolving loan funds

The City -- The city's role is one of coordination and funding. The city:

- increases capital improvements and services to the district
- helps to fund a revolving loan fund for nonbankable business or real estate loans
- helps to develop and enforce design standards
- helps to develop and maintain a Special Assessment District
- helps to fund the development of the program

In order to make important decisions and manage staff, the partnership establishes a nonprofit corporation with a specific description of purpose and by-laws. The board of directors of the corporation has the authority to hire and manage a staff which is headed by a Neighborhood Business Center manager who is responsible for advertising, promotions, community relations, sanitation, security and maintenance. These functions must be performed continually and should be paid for by the business owners through an equitable assessment arrangement.

The Role of Neighborhood Reinvestment -- Neighborhood Reinvestment acts as a catalyst to bring the partnership together and to develop the program. In doing so, Neighborhood Reinvestment:

- conducts a detailed market study of the business district to ascertain its potential
- enters into a development agreement with a local entity (usually city government) to assist local merchants, property owners, residents, financial institution representatives and representatives from local government in creating a Neighborhood Business Center program
- conducts a careful survey of local resources and secures the interest of institutions and individuals concerned with neighborhood preservation
- hires and manages a temporary, full-time Neighborhood Business Center manager to immediately activate the program
- conducts an educational process featuring several workshops designed to acquaint representatives of all segments of the partnership with operational details of the program, and assists them in fitting the options to local needs
- assists in the organization of the partnership structure and selection of permanent staff for the program
- provides training and technical assistance to the program staff during the development phase and later stage of operation

Accomplishments

The model is currently being replicated/refined in the West End neighborhood of Atlanta, Georgia and the East Main Street neighborhood in Bridgeport, Connecticut.

NEIGHBORHOOD PRESERVATION PROJECTS

Program Goal

The goal of Neighborhood Preservation Projects is to seek out promising strategies and new tools for reversing factors causing neighborhood decline.

These new tools enable NHSs to deal with the ever-tightening rental market, more distressed neighborhoods, neighborhoods with higher proportions of renters and apartment buildings, more blighted buildings, scattered vacant lots, blighted commercial areas, etc.

Methods of Achievement

The goal of Neighborhood Preservation Projects is achieved by a three-part process which includes:

1. Identification/Selection

NPP searches for effective local strategies that can become useful program tools in other neighborhoods. In choosing projects to support, NPP uses the following criteria:

- Meets a substantial need - Initially, the proposed project is analyzed to ensure that it meets an important and demonstrated need, and that the project will solve a local problem that has been identified by people working in the neighborhood.
- Demonstrated capacity - The sponsoring organization must have operational experience and demonstrated capacity to conduct the project. This may be an NHS or similar community-based organization, or in some cases, a local government working closely with a neighborhood association.
- Partnership approach - The sponsoring organization must also have active participation by other neighborhood partners such as lenders, residents, merchants, and local government. In addition, local government should be willing to provide financial resources and technical assistance to the project.
- Provides information - The project must be capable of providing the practical information needed for neighborhood reinvestment, to develop a workable demonstration project in other neighborhoods.

2. NPP Monitoring and Evaluation - Documenting Results

Once promising projects are selected, NPP requires each project to collect and provide information which is monitored during the project and then evaluated at the end of the contract.

- Monitoring - The original work program is the framework for observing the project. NPP periodically examines the following:

  -Structure - How the project is organized to do business.

  -Operations - What activities are undertaken to reach the goal.

  -Outputs - What has been accomplished, such as units rehabilitated, houses sold, tenants converted to owners, and increase in merchant sales.

NPP also gives technical assistance to projects which need help in meeting objectives.

- Evaluation - The reporting process and our technical assistance provide the necessary information to determine 1) whether the program works and 2) whether it can be replicated in other neighborhoods.

  -Does it work? - The project must clearly show that it meets a neighborhood need effectively and does it in a way that draws on the original partnership.

  -Is is replicable? - NPP must then determine whether the essential elements are broadly applicable in NHS neighborhoods. In order to make this judgment, we bring in other NHS neighborhood staff to discuss the use of the new program tool.

3. Packaging Model for Replication

The final step is to pull together all that thas been learned into a format that fully describes the model and becomes the basis for pilot replication by the Neighborhood Program Development division. The information includes:

-a history of the program's development
-a description of the program's essential elements and time requirements for implementation
-a description of the partnership and the resource commitment level
-a description of the organizational form and staffing patterns
-a description of the target neighborhood and program impact.

This becomes the blueprint program model and instructional base for testing the new tool in other neighborhoods.

<u>Accomplishments</u>

All of the programmatic components now in the replication stage were originally successful Neighborhood Preservation Projects. These have included:

<u>Apartment Improvement Program (AIP)</u> - from the City of Yonkers (NY) Apartment Building Rehabilitation Project

<u>Neighborhood Conservation Services (NCS)</u> - from the Berkeley (CA) Pilot Rehabilitation Project

<u>Home Ownership Promotion (HOP)</u> - from the Baltimore NHS Home Ownership Development and Marketing Project

<u>Problem Properties Strategies</u> - from the Jamaica Plain (Boston, MA) Vacant Housing Renovation Project; City of Baltimore 26(E) Project; Pueblo (CO) NHS Rehab Training Project; Stop Wasting Abandoned Properties (Providence, RI) Project

<u>Statewide NHS Foundation</u> - from the California NHS Foundation

<u>Owner-Built Housing</u> - from the Elmhurst NHS (Oakland, CA) Owner-Built Housing Project

<u>Energy Conservation</u> - from the Elmwood NHS (Providence, RI), Ferry Village NHS (South Portland, ME) and Salt Lake NHS (Salt Lake City, UT) Energy Conservation Projects

<u>Neighborhood Business Centers</u> - from nine separate projects in the following cities: Toledo (OH), Cleveland (OH), Philadelphia (PA), Portland (OR), Baltimore (MD), Chicago (IL), Atlanta (GA), and Bridgeport, (CT)

NEIGHBORHOOD PRESERVATION PROJECTS
Currently Funded Demonstration Projects

ENERGY CONSERVATION

- Ferry Village NHS Energy Conservation Project
  (South Portland, Maine)

  Ferry Village NHS is systematically integrating energy conservation audit and repair procedures into its operations. Energy conservation is being tested as an alternative to sensitive code enforcement in the marketing of the NHS's comprehensive rehabilitation services In-home discussions and workshops for small groups of residents also demonstrate cost-effective do-it-yourself energy conservation techniques.

- Salt Lake NHS Energy Conservation Project
  (Salt Lake City, Utah)

  Salt Lake NHS is coordinating the full spectrum of existing energy conservation resources for its neighborhood. Partners with the NHS in this effort include city and state governments utility companies, schools, lending institutions contractor trade associations and community action programs The comprehensive energy conservation plan evolved in the NHS neighborhood will serve as a model for other neighborhoods in the city.

- Ford Foundation Energy Conservation Projects

  Neighborhood Reinvestment Corporation has been awarded a Ford Foundation grant to support energy conservation projects in NHS and AIP neighborhoods. Grant funds are available over two years beginning April 1981. Five distinct project activities are being undertaken in an effort to expand upon and consolidate information already gained from demonstration projects funded by Neighborhood Reinvestment in the past NPP is providing technical assistance in the development of all five energy conservation projects All projects will be monitored and program models will be refined from their experience for replication in other NHS and AIP neighborhoods.

  - NHS of Rochester Energy Conservation Project
    (Rochester, New York)

    NHS of Rochester is testing a program model for packaging energy conservation loans for lending institutions, local government and utilities in conjunction with the full range of rehabilitation services already offered by NHSs. The NHS is developing a comprehensive delivery system for all energy conservation resources needed by its neighborhood.

- Highland NHS Resident-Centered Project
(Denver, Colorado)

Highland NHS is assisting neighborhood residents in developing professional skills to deliver energy conservation services to their neighbors. Groups of volunteer residents, including senior citizens, are being trained as energy auditors. Those residents will do energy audits and train others in weatherization techniques, providing the time-consuming hands on assistance which highly paid utility auditors cannot provide. The NHS will coordinate all activities and provide in-depth financial, rehabilitation and conseling back-up.

- Chelsea NHS Small Apartment Building Project
(Chelsea, Massachusetts)

Chelsea NHS has developed a model approach for integrating energy conservation techniques into the rehabilitation and management of 2-6 flat apartment buildings. The NHS is making available to its neighborhood exciting new energy conservation technology such as a specially engineered blower door for diagnosing the particular needs of individual buildings. The cost-effectiveness of neighborhood self-help weatherization efforts when coordinated by the NHS is being tested.

- AIP Large Apartment Building Project
(New York, New York)

Neighborhood Reinvestment is assisting the AIPs in the Northwest Bronx and Pelham Parkway neighborhoods to integrate energy conservation into the process of refinancing, rehabilitating and managing large apartment buildings. AIP's computer programs for the complete financial analysis of apartment buildings are being revised to include the impact of energy conservation alternatives.

Technical assistance from an experienced energy conservation engineer is available to the AIPs. Modifications to the analysis of building needs and rehabilitation specifications are being made for maximum energy efficiency.

- Energy Conservation Training

The Neighborhood Reinvestment Training Department in Chicago is developing a model energy conservation curriculum and training approach for NHS staffs. Members of those staffs will be trained in energy conservation technology community education and program development. An energy conservation newsletter, "Weathervane," will be published regularly to update the training. It will initially be directed toward NHS neighborhoods, but may later be broadened to include other organizations serving neighborhoods.

NEIGHBORHOOD RENTAL RESOURCES

- Baltimore NHS Rental Services
  (Baltimore, Maryland)

  The Baltimore Patterson Park NHS is addressing the problems of displacement through the Neighborhood Rental Services Program. The Neighborhood Rental Service is a separate corporation formed by the NHS to acquire rehabilitate and rent problem rental properties on specific target blocks. The program combines acquisition loans from the NHS High Risk Revolving Loan Fund, Exis ing Section 8 Housing Assistance Payments and 312 loans. After rehabilitation the properties are rented to neighborhood residents

- Chicago NHS Mutual Housing Conversion Project
  (Chicago, Illinois)

  The Chicago NHS's Redevelopment Corporation (NHSRC) is pursuing a pilot process which encompasses the concepts of mutual housing, turnkey development and the attraction of private investment capital. NHSRC is renovating and stabilizing the tenancy of a moderate-sized apartment building for conversion to ownership by a mutual housing association.

- Ithaca NHS Scatter-Site Project
  (Ithaca, New York)

  Ithaca NHS will acquire and rehabilitate 55 units of scattered site rental housing over two years At the end of the first year of operations the NHS will evaluate alternative options for ownership fo the units inorder to maintain community control. The NHS will finance the project with construction mortgages from lenders combined with CDBG funds While units are being rehabbed tenant leadership will be developed. The educational process will be geared toward preparing the tenants to participate in the discussions and final decisions concerning alternative forms of ownership.

- Flatbush Development Corporation
  (Flatbush, New York)

  The Flatbush Development Corporation Housing Management Program is a nonprofit community-based apartment management service. The program provides comprehensive professional management services to landlords on a fee basis, allowing the operating expenses of the service to be partially offset from management income. The institution of sound management practices will include planned reinvestment and maintenance while yet not forcing the displacement of present low- and moderate-income tenants.

NEW CONSTRUCTION IN OLDER NEIGHBORHOODS

- Chicago NHS In-Fill Housing Project
  (Chicago, Illinois)

  The NHS Development Corporation, a non-profit subsidiary of NHS of Chicago, is constructing single-family homes on scattered vacant sites

in the Heart of Chicago NHS neighborhood. The city provides funds for acquisition, and local lenders provide construction and permanent mortgage financing The NPP grant is being used for down-payment assistance to qualified home buyers in order to reduce the cost of construction and bring the sales price within the neighborhood real estate market. The NHS markets the houses screens potential buyers, selects finalists by lottery and assists in loan processing and closing.

- Elmhurst Scatter-Site In-Fill Housing Project
  (Oakland, California)

  The Urban Housing Institute is analyzing a scatter-site in-fill housing project to determine (1) job site security, (2) cost-reducing construction techniques and (3) anti-speculation deed restrictions which could apply to NHS neighborhoods.

NEIGHBORHOOD-BASED EDUCATION

- Liaison Citizen, Inc.
  (Los Angeles, California)

  Liaison Citizen is a sixteen-week program which trains youth and adults in communications and citizenship skills. The program is designed so that trainees will better understand and function within the governmental/political system thus enabling them to contribute positively to their communities At the conclusion of the training program, graduates involve themselves in creative community projects. The program operates in the Crenshaw neighborhood and is coordinated with the Neighborhood Reinvestment Apartment Improvement Program.

- Foundation for Community Service Television
  (Los Angeles, California)

  The Foundation for Community Service Television has formed a partnership with the Inglewood School Board, the Inglewood NHS and a local cable operator to offer high school students the opportunity to use video programming to document the background and culture of the community. This project is designed to enhance the tudents communications skills and positive sense of community through an innovative school curriculum and neighborhood filming experiences. The resulting video programs are made available to neighborhood cable television viewers.

ARSON PREVENTION

- Northwest Bronx Community and Clergy Coalition
  (Bronx, New York)

  The Coalition, operating in the Northwest Bronx AIP neighborhoods, is testing an arson prevention program model which: 1) develops information relevant to incidence of fires, 2) targets at risk buildings, 3) organizes building residents, 4) negotiates with building owners, and 5) stabilizes buildings with appropriate financing, rehabilitation and management treatments.

NHS RESIDUAL SERVICES

- Baltimore NHS Neighborhood and Home Maintenance Project
  (Baltimore, Maryland)

  The Baltimore NHS is addressing some of the needs of a mature NHS in a two-pronged maintenance strategy aimed at certain individual homes and the neighborhood in general. Home Maintenance provides routine and emergency home maintenance service at a nominal fee to homeowners physically and/or economically unable to perform routine maintenance, i.e., the elderly, the handicapped, and the single-parent households. Neighborhood Maintenance provides a residual service in NHS and other neighborhoods where major private and public reinvestment has occurred, to both lessen the potential of displacement and to prevent future neighborhood decline.

NEIGHBORHOOD HOUSING SERVICES OF AMERICA, INC.

Neighborhood Housing Services of America, Inc. (NHSA), was established as a private nonprofit, state chartered, tax exempt corporation in 1974 to give added private sector strength to the NHS programs, and through a secondary market give the NHS programs access to the private investor market as a resource for replenishing their loan funds.

It was anticipated in NHSA's formation that this and other activities to meet common needs of the NHS programs would be carried out by NHSA in cooperation with Neighborhood Reinvestment. This approach has been effective and its continuation was authorized in the enabling legislation for Neighborhood Reinvestment:

> "The Corporation (Neighborhood Reinvestment) shall continue the work of the Urban Reinvestment Task Force in supporting Neighborhood Housing Services of America, a nonprofit corporation established to provide services to local neighborhood housing services programs, with grants to expand its national loan purchase pool, and may contract for service which it can perform more efficiently or effectively than the Corporation."

NHSA is a California corporation headquartered in Oakland, California. Its by-laws call for a 15-member board of directors and it currently operates with a board of 12 members and a staff of 21 persons located in Oakland, Washington, D.C. and Baltimore, Maryland. The staff was organized to contain all the staff and partnership skills involved in the NHS programs -- financial, community and governmental processes -- and on the basis of these skills is able to make contributions to many aspects of Neighborhood Reinvestment's work related to NHS operations in general as well as to the NHS revolving loan fund operations.

NHSA's board of directors includes volunteers representing the same resident-city-financial industry partnership which is the foundation of all the NHS programs and functions as a resource board for the NHS programs both technically and substantively.

Secondary Market Operations

NHS loans are by definition "unbankable" and require terms more liberal than the private investor market accepts. As a result, the approach to creation of the NHSA secondary market has been the use of a combination of grant funds from Neighborhood Reinvestment and loan purchases with recourse to meet the needs of early programs while building a solid pool of loans for later sale to private investors.

The arrangement grew into a true secondary market in 1978 when the Equitable Life Assurance Society of the United States agreed to invest up to $1 million in NHSA notes backed by NHS loans, thus introducing private sector funds into the process. In 1980, Equitable agreed to purchase an additional $2 million in NHSA notes, demonstrating its continued confidence in the effectiveness of the program.

As it now works, NHSA continues to buy loans made to unbankable homeowners to facilitate rehabilitation of their homes from local NHS programs. Then it sells a note to Equitable using the loans as collateral. The major stipulations require that each NHS can sell loans amounting to no more than half the loans in its revolving fund; that the loans used as collateral by NHSA must amount in value to 125 percent of the note to be sold to Equitable; and that any loan unpaid for more than 90 days must be bought back by the NHS or replaced by one of equal value. Neighborhood Reinvestment grants to NHSA provide capital, operating funds and funds to cover the differential between NHS loan yields and the below-market rate required by the institutional investor.

Recently, an important milestone in the secondary market was achieved when the Prudential Insurance Company announced a $5,000,000 commitment to a special secondary market first-mortgage fund designed to provide below market financing for Problem Properties Strategies. The commitment is for the purchase of collateralized securities from NHSA in the amount of $2,500,000 in each of two years. The securities are to be for a 25 year term and bearing an interest rate of 9½%. Final details of the agreement are being worked out between Prudential and NHSA. The availability of this resource will give a burst of new life to the Problem Properties Strategies of NHS programs throughout the country. Prudential calculates that the present value of the foregone interest earnings in making this below market commitment is the equivalent of a $2,300,000 contribution to NHSA.

Educational Development

NHSA, at the request of Neighorhood Reinvestment, has taken the lead in a long-term educational development project.

Because of the new fields of training inherent in NHS and the generally limited educational resources available in non profit organization administration, NHSA is undertaking the development of educational resources for the NHS network at the following levels: internships; bachelors degree programs, master degree programs; and seminars in continuing professional education.

The objective at each level is to institutionalize the results so that as large a measure as possible of the nation's public/private educational institutions can pick up the long-term responsibility for providing for the educational needs of the NHS network.

One segment of the integrated model designed to achieve this goal is a special masters degree program at the University of San Francisco. The 13-month program, developed by NHSA and the university, highlights nonprofit housing/neighborhood revitalization concerns, and uses the NHS as a centerpiece.

In addition to working on the composition and development of the program's curriculum, NHSA also was able to: obtain priority status for the admission of NHS staff members to the program; participate in the recruitment and selection of candidates; and obtain an agreement from the university to replicate the program at its Los Angeles campus. NHSA and Neighborhood Reinvestment are also pursuing opportunities of conducting similar programs at a number of additional institutions.

Of the 14 students working for a Master of Public Administration degree with a specialty in housing, 3 are affiliated with an NHS, NHSA, or Neighborhood Reinvestment. At the urging of NHSA, most of the remaining students were recruited from community development programs in NHS cities.

Financial Development

To cope with the difficult operating conditions for NHS programs, Neighborhood Housing Services of America is providing leadership to broaden the base of private corporate support for local programs. Three tracks are currently being followed to accomplish this:

In the first track, training is being provided for staff members of Neighborhood Reinvestment and NHSA to enable them to provide technical assistance to local programs in expanding their local contributions base in the local corporate community. Training has also been conducted on a regional basis for NHS board members and NHS executive directors. Every NHS has participated in this training. Again, the focus is on each program enlisting corporate leadership to assist in broadening its local contributions base for operating budget and, where possible, the revolving loan fund.

In the second track, intensive technical assistance is being provided to selected NHS programs. This performs two functions: first, it provides assistance to specific programs where the need is great. For instance, the technical assistance is being provided in the City of New York, where a major expansion of the program to six new neighborhoods is underway, in the Twin Cities which has just completed expansion to three additional neighborhoods, in Cleveland which is undertaking an expansion, and it will be provided in Los Angeles where a new multi-neighborhood development is about to get underway. The second function of this effort has been to provide a laboratory to adapt general fund raising techniques to the specific needs of NHS programs. Out of this experience NHS fund raising handbooks have been developed. Finally, this provides an important training ground for NHSA fund raising staff.

The third track is to develop a national fund raising campaign which will be managed by NHSA with the assistance of Marts & Lundy, fund raising counsel. This campaign will have a goal in the order of magnitude of $30,000,000 and will be targeted at: (1) additional capital for the secondary market, permitting it to be expanded and made more flexible in increasing the flow of funds into NHS revolving loan funds through sale of loans to NHSA, and (2) financing "hands-on" technical assistance including actual campaign management in statewide and regional fund raising for NHS operating, revolving loan funds and special project needs.

MUTUAL HOUSING ASSOCIATION DOCUMENTS

The following documents are provided as examples of the developmental work taking place in the demonstration Mutual Housing Association in Baltimore, Maryland. The first item, "Summary of Assumptions Established at Easton Workshop," was a set of guiding principles for development of the Mutual Housing Association agreed to in the first partnership workshop in September, 1981.

The items which follow are taken from the partnership workshop which took place on March 26-27, 1982 and represent committee presentations and recommendations made to the group as a whole. They include a recommendation on membership policy by the Membership Committee; recommendations on operating policies by the Operations Committee; and recommendations of the Structure Committee including a recommended mission statement, articles of incorporation, and proposed bylaws for the Mutual Housing Association of Baltimore.

APPENDIX B, Pg 1 of 34
'Workshop I Assumptions'

SUMMARY OF ASSUMPTIONS
ESTABLISHED AT THE EASTON WORKSHOP
FOR THE
MUTUAL HOUSING ASSOCIATION OF BALTIMORE

1. The Association would comply with spirit of its mission to be a continuous and ongoing producer of new and rehabilitated housing affordable to lower and moderate income members.

2. The Association would build quality, long-lasting housing and provide quality maintenance and management.

3. The Association would employ highly competent professional staff to insure both ongoing production and quality management and maintenance.

4. The Association would be a non-profit corporation.

5. The Association membership and Board would be composed of a partnership of resident and waiting resident members, neighborhood and city-wide leaders, city government representatives, business leaders with expertise in housing, and other interested parties.

6. The Capitalization Grant, which makes it financially possible for the Association to provide housing at affordable neighborhood market levels, would be conditional upon compliance with the non-profit housing provider mission, and participation in the ongoing relationship with the Neighborhood Reinvestment Corporation geared to assure that the obligations of the Association were being met.

7. The Neighborhood Reinvestment Corporation would serve as Grantor or Agent for the capital grants and would assist the Association in becoming organized and completing its initial development. Following development, Neighborhood Reinvestment would maintain an ongoing relationship of available technical assistance, training, monitoring and auditing related to grant agreement conditions.

8. The Board of the Association would be a partnership Board with the sum of the occupant and waiting resident members comprising the numerical majority (i.e., one more than half).

9. The Association would remain the sole owner of its housing, and would not participate in limited partnership or tax syndication schemes.

10. After providing for maintenance and other costs, all available resources of the Association would be utilized for the continued production of additional housing units.

11. No specific income mix requirements would be established. Rather, the goal of the Association would be to serve members at income levels typical the NHS neighborhood.

12. The Association would come as close as possible to bringing homeowner standards to the nature and quality of the housing opportunities it offers its members. Specifically, it would provide mechanisms which would:

a. Assure that homeowner quality is obtained in the quality of the living environment and the quality of the maintenance of each living unit and the complexes of homes as a whole.

b. Assure that the resident members have an effective voice in the management of the Association and effective influence over the cost of maintenance within high standards and similar to the role of a homeowner.

c. Provide a way for its members to "get ahead" of traditional rental situations. Mechanisms would be used such as setting monthly fees to cover direct costs without paying a profit to anyone, as well as opportunities to build up credits on membership fees which could be applied toward later reduction of monthly fees.

d. Provide for stability through long term membership, including the opportunity for membership by successive generations.

TABLE OF ORGANIZATION AND RELATED GENERAL RESPONSIBILITIES

THE MEMBERSHIP

A partnership of residents, waiting residents, community leaders, government representatives, technical resources.

Roles:

1. Set broad policy and long-term goals
2. Elect Board of Trustees

THE BOARD OF TRUSTEES

A partnership reflecting all of the categories of members

Roles:

1. Set interim policy and short-term goals
2. Oversee financial affairs
3. Set staffing pattern, hire director
4. Plan and carry out development of additional housing
5. Approve membership applications
6. Establish committees and councils

THE COUNCIL

Partnerships of complex residents and residents of the community adjacent to the complex

Roles:

1. Develop budget for complex
2. Apportion certain exterior maintenance responsibilities
3. Monitor all maintenance
4. Screen resident members
5. Recommend complex policy on common space, pets

MUTUAL HOUSING ASSOCIATION OF BALTIMORE, INC.

MEMBERSHIP POLICY

The Mutual Housing Association of Baltimore, Inc., is a membership organization designed to bring together a diverse group of persons committed to the Mission of the Association to provide long-term secure housing for its members.

Four classes of Membership are provided for in Article II of the Bylaws of the Association, adopted , 1982. These Membership categories are described in detail below, along with other pertinent facts.

Class A (Pre-Resident/Resident) Membership

Description

A person who has submitted an application for residence in a dwelling unit owned by the Mutual Housing Association of Baltimore, whose application has been approved by the Association, and who has executed a Membership Agreement is granted a Class A Membership in the Association. This type of membership may be held by persons who have not yet moved into a unit as well as those who already reside in a mutual home.

Privileges of Membership

Class A Membership in the Association entitles the Member to participate in all affairs of the Association including serving on the Board of Trustees and committees. Once a Member moves into a mutual home, he also becomes eligible to serve on the Council of the complex in which he resides.

When two or more persons apply as co-applicants for the same housing unit and are approved, they hold one Class A Membership and are entitled to cast one indivisible ballot on each issue to come before meetings of the Association.

Application Procedure

In order to be considered for Class A Membership and residence, all persons whose income will be used to support the household and to pay monthly expenses must participate in the application process. In the case of married applicants, both spouses must participate, whether or not both are employed.

Applications may be filed by appointment only, at the Mutual Housing Association office at 3401 Greenmount Avenue. A $30.00 non-refundable application fee will be charged for each applicant to cover the cost of a credit check and administrative processing. In a case where separate credit checks must be made for co-applicants, a $30.00 fee will be charged to each person.

Screening of Applications

The Association desires to equitably and fairly review all applications which are submitted. The goal of the review process is to select economically qualified persons from diverse backgrounds who are interested in being a part of a mutual self-help effort to achieve secure, long-term homes for themselves and others.

The intent of the review process is:

* To assure that applicants selected to reside in Association homes have sufficient economic resources to carry their share of the financial responsibilities of mutual housing.

* To assure that members do not jeopardize the financial interests of all other members because of an inability to pay the monthly fee in full and on time.

* To selec members who understand and will fulfill all the responsibi ities of living in mutual housing.

* To select members who will maintain a pleasant living environment.

Selection Criteria

Income: Two standards must be met:

(1) Projected monthly housing expenses may not exceed 33 percent of the household's gross monthly income. Income includes all wages, salaries, overtime, tips, alimony, pensions and other income such as interest dividends, stocks, bonds, etc.

and

(2) Projected monthly expenses for housing and long-term debt may not exceed 43 percent of gross monthly income. Long-term debt is defined as debt with a repayment period exceeding 10 months. This would include revolving charge and redit cards, personal loans, insta lment debt, alimony, child support and separate maintenance obligations, auto, boat, truck loans, etc.

Credit Check

A good credit rating as verified by a credit bureau is necessary. Applicants who have never established credit (e.g. students or persons who have no revolving charge or credit cards) must provide sufficient evidence of credit worthiness. By signing the application form, applicants authorize the Association to check their credit.

Employment, Income and Deposit Verification

Names, addresses and phone numbers of employers are requested on the appl cation so the Assoc ation can verify the applicant's employment and earnings. Only verifiable income will be considered in meeting the ncome standards outlined above. For example ncome tax returns from a previous year could be used to ve fy nearned income, or a copy of court orders or separation papers could be used to verify alimony or child support payments.

Current/Previous Landlord Check

Information will be solicited from the applicant's current or previous landlord regarding: (a) whether the applicant was timely or delinquent in making monthly rent payments, (b) whether the applicant was a good tenant and the nature of any problems encountered, and (c) if given the opportunity, whether the landlord would rent a unit to the applicant again.

Letters of Reference

Two current letters of reference from relatives, friends, work col eagues or social acquaintances will be requested.

Interview

The Association requires that each applicant be interviewed. Joint applicants may be interviewed together The interview would cover any area suggested by the app cant; the applicant's understanding of the nature of mutua housing; the Association's Bylaws, organizationa structure, rules, procedures and other relevant factors. An interview in the applicant's own home may be requested. At its discretion, the Board or Membership Committee may waive the interview requirement.

Membership Fee and Payment Schedule

A ass A Member is required to pay a membership fee to the Association, equal to 5% of the estimated cost of the dwelling unit for which the person has applied As spelled out in the Membership Agreement which would be signed by the Association and the Member this fee represents a loan to the Association, repayable with nominal interest at a rate set by the Board of Trustees. The fee is repaid to the Member when he terminates Membership and, if the Member is in residence, when he terminates occupancy as well.

Within 15 days of notification of approval of an application for Class A Membership the applicant must sign a Membership Agreement and remit a portion of the membership fee as specified in that Agreement.

A payment plan will be agreed upon at the time the Membership Agreement is executed. The final payment of the membership fee will be due 75 days prior to availability of a unit. This due date will also be specified in the Agreement.

Failure to meet any payment deadlines will result in termination of the Agreement and the Member's priority to occupy a unit.

Termination of Membership

A Class A Member who has not yet moved into a mutual home may terminate Membership by giving 30 days written notice. However, if the Member terminates after the Association has notified him that a dwelling unit is ready for occupancy, he may have to reimburse the Association for actual lost income, up to a maximum of one month's occupancy charge. This penalty would only be required in the event the shortness of the cancellation notice does not allow the Association adequate time to approve a new member, and to have that member occupy the unit without loss of income to the Association.

The Association may terminate the membership of a Class A Member who has not yet established residence in an Association-owned housing unit if the person violates the terms of the Membership Agreement, including failing to make payments required at the times or in the amount specified, submitting false information on the application for membership, or engaging in conduct detrimental to the Association's interests.

Prior to termination, the member would be afforded an opportunity to be heard by a designated committee of the Board of Trustees which would then make a report and recommendation to the Board on action to be taken. A majority vote of the Board would decide the issue.

A Class A Member who resides in a mutual home may terminate his membership by giving the Association 60 days written notice and by vacating the dwelling unit in accordance with the Occupancy Agreement he has signed.

The Association may terminate the Class A Membership of a resident if that Member fails to live up to the terms agreed to in the Membership Agreement, or if the Member has engaged in conduct detrimental to the interests of the Association.

Prior to termination, a designated committee of the Complex Council would give the resident an opportunity to be heard and would then make a report and recommendation to the Complex Council. The Council would make the final decision by majority vote.

In all cases of termination of Class A Membership, the sum of the membership fee plus accrued interest, but minus any obligations outstanding to the Association, would be returned to the Member in accordance with the Membership Agreement.

Class B (Waiting Resident) Membership

Description

Each year the Board of Trustees of the Association will review its housing product on plans for the coming year, and based upon this estimate and projected vacancies in existing Association-owned housing, wi l establ sh a reasonable number of Class B Memberships which may be granted for the next year.

A Class B Membership is held by a person who would like to apply for Class A Membership and residence in Association-owned housing when such ppl cations are being accepted, and desires in the meantime to participate in the Association and to establish a place on a waiting list.

Privileges of Membership

Class B Membership entitles the Member to participate in all affairs of the Association including serving on the Board of Trustees and committees. When two or more applicants apply together they hold one Class B Membership and are entitled to cast one indivisible ballot on each issue to come before meetings of the Association.

The Class B Member's name is placed on a waiting list for the desired size housing unit and the Member receives a priority number for filing an application.

As housing units become available, the Class B Member can be assured of being given an opportunity to apply when his name reaches the top of the list. If the Member declines to apply when his priority number is reached, his name will be dropped to the bottom of the list; he will be offered one more opportunity to apply when his name reaches the top of the list a second time.

Application Procedure

In order to become a Class B Member, a person must submit a Request for Membership to the Association accompanied by a check for the dues stipulated by the Board of Trustees (see below).

When the limit of Class B Memberships set by the Board has been reached, no additional requests and dues will be accepted.

Membership Dues

To become a Class B Member and receive a place on the waiting list, a person must remit a check for $15 with his Request for Membership. This sum will be credited toward the Member's application fee when he applies for Class A (Pre-Resident/Resident) Membership.

The Membership dues is not refundable and will be retained by the Association in all cases.

Termination of Membership

A Class B Member may resign his Membership at any time by notifying the Association. His priority number on the waiting list is not transferrable and the membership dues will not be refunded.

After a Class B Member has been afforded two opportunities to apply for residence in an Association-owned unit, his Membership in the Association will automatically expire as soon as a new Class B Member is named.

The Association may terminate the Membership of a Class B Member for conduct detrimental to the interests of the Association. Prior to termination, a designated committee of the Board would give the member an opportunity to be heard and would then make a report and recommendation. A majority vote of the Board would decide the issue.

Class C (Community Interest) Membership

Description

This membership category includes community leaders, both from neighborhoods where mutual housing is located and from other communities in the City of Baltimore, representatives of local government, lenders and other business or real estate professionals, philanthropic and religious leaders, and other technical or financial resource persons with a variety of interests and expertise to share in meeting Association goals and carrying out its program.

Privileges of Membership

Each Class C Member is entitled to cast one ballot on each issue to come before meetings of the Association, and is eligible to participate in all Association affairs including serving on the Board of Trustees and committees. In addition, some Members are eligible to serve on the Complex Councils.

Election Procedure and Term of Membership

In order to become a Class C Member, an individual must be nominated by a member of the Association and that nomination must be approved by a majority of the ballots cast at an annual meeting. Once ratified, a Class C Member serves for a term of three years.

At the conclusion of the three year term, the member may be re-nominated and ratified once again to continue to serve. There is no limit on the number of consecutive terms a community interest member may serve in the Association.

Termination of Membership

A Class C Member may resign at any time, or his membership may expire at the end of the three year term if renomination and election does not occur.

The Association may terminate the membership of a Class C Member if the Member engages in conduct detrimental to the interests of the Association. Prior to termination, the

Member would be afforded an opportunity to be heard by a designated committee of the Board who would make a report and recommendation on action to be taken. A 2/3 vote of the Board of Trustees will terminate a Class C Membership.

Class D (Associate) Membership

Description

In order to assure the broadest possible base of participation in the Association, and to carry out the Association's Mission to educate the public and disseminate information regarding its activities, Class D or Associate Membership has been established. Class D Membership may be granted to persons or organizations who have made financial or other contributions to the Association, or who wish to be kept informed of the Association's activities or to participate in the activities of the Association.

Privileges of Membership

Class D Members may attend the public meetings and other open functions of the Association. They may occupy a place on the mailing list for receipt of Association newsletters, materials and reports. Class D Members may not cast ballots at meetings of the Association.

Membership Dues

From time to time the Board of Trustees may set dues to be paid by Class D Members to cover costs of mailing, reproduction, and other Member services.

Neighborhood Housing Services of America
BALTIMORE OFFICE
3401 GREENMOUNT AVENUE — 2ND FLOOR
BALTIMORE, MARYLAND 21218
Telephone: 301/889-1450

March 26, 1982

TO: Workshop III Participants and the Board of Trustees of the Mutual Housing Association of Baltimore

FROM: The Operations Committee

SUBJECT: Recommended Rules, Regulations and Operating Policies

Over the past six months the Operations Committee has met numerous times to discuss and draft an Occupancy Agreement. A description of major points to be incorporated into the final Agreement is attached.

Additionally, we have held a number of discussions and have consulted professional property managers regarding some operating policies. We would like to pass along our recommendations so they may form the basis of rules and regulations and informal operating procedures for the management of Alameda Place.

I. Orientation for New Resident Members - We feel it is important for new residents to attend a session where the Occupancy and Membership Agreements are reviewed in detail. This session should also cover resident members' responsibility to participate on a voluntary basis in Association affairs and in complex maintenance.

II. Grounds Care - In general, resident members would be responsible for care of their own rear yards and the Association would coordinate maintenance of front yard , side yards and common areas. Resident Members may be asked to contribute time to general lawn and landscape maintenance in order to keep maintenance costs to a minimum.

III. Pets - Four-legged pets (not birds and fish) should only be allowed with prior approval of the Complex Council. The Occupancy Agreement would provide that any resident who receives approval for a pet must sign an addendum to the Agreement governing the housing of the pet. We recommend an dditional monthly fee of $5 be levied per pet to cover added wear and tear and maintenance costs which might result from the pet's occupancy.

IV. Lockouts - We have been advised that lockouts can become a major operational problem. We recommend a $2 charge be levied if someone is locked out during the normal business day. A $10 charge should be levied for lockouts after 5:00 p.m. and on weekends and holidays, since this would necessitate an overtime call to a maintenance person.

V. Occupancy Limits - We recommend the following occupancy limits by unit size:

1 Bedroom	2 persons, except an infant up to 12 months of age may be allowed in addition.
2 Bedroom	4 persons
3 Bedroom	5 persons, but no more than 4 adults (persons 18 or older)

VI. Guests - Any household having a guest more than 30 days must receive approval from the Complex Council. Residents may not ever overcrowd units with guests.

VII. Eviction Proceedings - The Committee recognized that in some exceptional circumstances it might be necessary to involuntarily terminate occupancy of a resident due to default or violation of lease provisions. The Committee recommends that the Board of Trustees, as soon as practical, develop some operating guidelines relative to eviction.

VIII. Security Deposit - The issue of a security deposit did not come up until quite late in our deliberations. On the advice of legal counsel we accepted the recommendation that a security deposit equal to one month's payment on a unit be established.

However, we felt it would be unfair to our initial residents to ask for a security deposit on top of a 5% membership fee since this had never been said to be a requirement. We therefore recommend that each membership fee be reduced by the amount of the security deposit for residents of the first phase of units.

We do understand the Association's need to generate adequate capital from the membership fees and that this reduction will affect the amount of capital available. We therefore think the Board of Trustees should consider a policy for future resident members regarding membership fees and security deposits.

MAJOR PROVISIONS TO BE INCLUDED IN THE OCCUPANCY AGREEMENT

Term

The initial term of the Occupancy Agreement will be for an extended term, most likely a three year period, with renewal options for one, two or three year periods. This is consistent with the Association's goal of providing stable, long-term housing for residents.

Monthly Fees

These are to be set at least annually by the Board of Trustees, more frequently if necessary, based upon the estimate of the total sum required to meet the Association's expenses.

Increases in Monthly Fees

The Association must give 75 days notice before increasing the monthly fee for a unit. When notified of such an increase, the occupant has the option of terminating the Agreement and vacating the premises by giving 60 days notice.

Late Charges

A late charge of 5% of the monthly fee will be levied for any payment received after the 5th day of the month. After the 9th day of the month, a late charge of 10% will be assessed.

Payment of Utilities

Occupants are required to pay for gas and electricity and any other utilities which are individually metered, including water if the Association should install meters to monitor water usage.

Repairs and Maintenance

The occupant is responsible for making any repairs necessitated by his own negligence or misuse or that of his family or friends, and for the redecoration of the interior of his dwelling unit during his occupancy. In addition, he is required to maintain his own rear yard.

The Association will repair and maintain the exterior of the buildings, appliances supplied by the Association (stove, refrigerator, disposal), and all major utility systems (heating, plumbing, electrical and air-conditioning).

Alterations, Additions, Improvements

Other than painting and papering, the occupant must receive the written permission of the Association to make any alterations, additions or improvements in or outside of the dwelling unit.

Occupancy

The occupant must specify within the lease, all of the persons who will occupy the unit. Any change in occupancy other than that specified would be a violation of the Agreement.

Transferrability

The Occupancy Agreement is not transferrable; an occupant may not sublet.

Renewal

The occupant may choose not to renew at the expiration of the Occupancy Agreement by giving the Association 60 days notice of his intention to leave.

The Association may not decline to renew an Occupancy Agreement unless the occupant has not complied consistently with the terms of his previous agreement, or unless the person has terminated his membership in the Association or has caused it to be terminated.

Neighborhood Housing Services of America
BALTIMORE OFFICE
3401 GREENMOUNT AVENUE — 2ND FLOOR
BALTIMORE, MARYLAND 21218
Telephone: 301-889-1450

March 26, 1982

TO: Workshop III Participants and the Board of Trustees of the Mutual Housing Association of Baltimore

FROM: The Structure Committee

SUBJECT: Final Report and Recommendations

The Structure Committee respectfully submits the attached draft Articles of Incorporation and Bylaws for your review and consideration. The Articles are intended to state the purpose of our organization, and the terms and conditions under which it will operate The Bylaws provide a detai ed framework of the proposed categories of membership and method of policy making for the Association and Board of Trustees In the three areas defined below, we felt our documents were better utilized as policy statements of the Board as they are more detailed than necessary for our Bylaws. We are therefore submitting the attached documents and explanation for subsequent consideration as Board policy.

THE COMPLEX COUNCIL

As part of our task, we carefully deliberated on the roles of the Members, the Board of Trustees, and the Complex Councils. Because the Complex Council is a new element in our structure, we spent much time discussing its purpose and relation to the Board of Tru tees We bel eve strongly that an effective Complex Council will be essentia for each development of Association housing. We have defined the broad purpose of the Councils in the Bylaws (Article IV, Section 0). We feel, however, that the residents of each Complex should have some flexibility in structuring their Council within Board guidelines. The attached draft, entitled Complex Counci Gu de ines, is intended as a Board document setting out framework within which the Complex Council can organize tself. Each Complex Counci would submit an organizational plan to the Board within thi framework for Board review and action. We recommend that the guidelines for forming Complex Councils be adopted.

MISSION STATEMENT

The Structure Committee also felt strongly that a clear statement of purpose and mission of the Association was needed and should be provided to each member. A summarized statement is found in the Articles of Incorporation. We recommend that the Board consider and adopt the attached Mission Statement as an operating document of the Mutual Housing Association of Baltimore.

FEDERATION OF COUNCILS

The Committee also deliberated over the need for coordination and linkage between the various councils for the purpose of educational exchange and furthering the Association mission of continued production of additional units. The Structure Committee feels that such a federation should receive serious consideration at a later date when a number of complexes of Association housing are operational. The following language is recommended as a statement of purpose of such a Federation:

The Board of Trustees may establish a federation of Complex Councils to further communication and coordination among Association members and to further the mission and goals of the Association. Some potential duties of the federation of councils include the following:

(1) To enhance the opportunities for communication, cooperation and education between and among the complexes through periodic forums or meetings;

(2) To create a broader sense of the mission and purpose of the Association through unifying the members;

(3) To strengthen the Association's collective ability to espouse the value and desirability of living in Association housing.

CONCLUSION

The Structure Committee has carefully discussed and reviewed each of the attached documents and recommends them for your adoption.

Attachments

MUTUAL HOUSING ASSOCIATION OF BALTIMORE

COMPLEX COUNCIL GUIDELINES

Section 1. Purpose - It is the intent of the Mutual Housing Association of Baltimore to encourage as much self-governance of individual housing complexes as possible, within the Association's broad policies and with the review and approval of the Board of Trustees. Therefore, at each complex of housing owned by the Association, a council shall be established for the purpose of recommending operating policies, planning and overseeing maintenance and improvements, monitoring of compliance with terms of resident membership by those persons residing in the complex, and coordination of events and activities.

Section 2. Relationship of Councils to Board of Trustees - Each housing complex council shall have the right to make recommendations to the Board of Trustees on policies which relate to the operation, improvement, maintenance, and related budgets of the complex. The chairperson of the Complex Council is automatically a member of the Board of Trustees.

Section 3. Organization of a Complex Council - As early as possible after Board approval of the resident members selected for a complex, or a section of a complex if development is being staged by phases, and no later than upon 100% occupancy of the complex, or section, an organizational meeting of all the resident members of a complex will be held. At such meeting an organizational committee shall be established by those present to develop a complex council plan to be presented to the Board of Trustees of the Association for review and approval within 45 days, and for review and approval to all the resident members of the complex within 60 days.

The complex council plan will address the following provisions, taking into account any of the limitations included below.

(a) Composition and number of delegates - The plan should recommend a size for the complex council, and in no case should the complex council comprise a number greater than 25% of the complex households. The plan also must include some proportional representation in the complex council of community interest members of the Association who reside in the surrounding neighborhood in which the complex is located. In all cases, however, complex residents shall be in the majority on the council.

(b) Method of nomination for delegates and plan of representation.

(c) Date of first election and period of time for subsequent elections.

(d) Term of office of council delegates - The plan shall include an annual election of council delegates at a meeting open to all resident members of the Complex.

(e) Successive terms - The plan may include any recommendation deemed appropriate from restricted to unrestricted successive terms. However, the plan shall limit the ability of any member to serve as an officer of a Complex Council for more than four successive years.

(f) Filling of vacancies and removal of delegates - Plan to include timely filling of vacancies by election of remainder of Complex Council members; remova of delegates to require at least 2/3 vote of Council or be based on an attendance requirement.

(g) Compensation of delegates - In no case shall a complex council delegate be compensated for his work as a delegate beyond the reimbursement of authorized expenses.

(h) Meeting of the council and general membership of the complex.

(i) Quorums.

(j) Committees.

(k) Officers - Each complex shall have a minimum of four officers--Chairperson, Vice-Chairperson, Secretary and Treasurer.

(l) Process for selection of officers.

(m) Duties and powers of officers - This shall include a provision that the Chairperson of the Complex Council will automatically serve on the Board of Trustees of the Mutual Housing Association of Baltimore.

(n) Adopt a monitoring and termination procedure within the policies established by the Board of Trustees

Section 4. Powers and Duties of Housing Complex Councils - Issues and tasks which would come under the purview of complex councils are:

(a) Planning of ma ntenance nd improvements for the complex, and utilization and upkeep of common areas.

(b) Establishment of gardening and landscape plans and restrictions.

(c) Participation in the development of an annual operating budget for the complex, within Board guidelines for Board of Trustees approval.

(d) Monitoring and enforcement of compliance with terms of occupancy or other membership agreements, including action to terminate membership and occupancy agreement where appropriate.

(e) Recommendations to the Nominating Committee of the Board of resident members to be elected to the Board.

(f) Mediation and resolution of neighbor disputes.

Complex Councils would also convene open meetings and forums for all complex residents periodically as needed for communication and information sharing, and would coordinate the participation of the complex in community events and activities.

MUTUAL HOUSING ASSOCIATION OF BALTIMORE

STATEMENT OF MISSION

The mission of the Mutual Housing Association of Baltimore is to develop, own and manage quality housing in the public and community interest.

The goal of the organization is to combat community deterioration, preserve neighborhood stability and provide predictable, quality homes and security from displacement. The Mutual Housing Association of Baltimore, as part of a national demonstration aimed to develop a new and workable form of secure housing, intends to cooperate with the Neighborhood Reinvestment Corporation in carefully evaluating the effectiveness of mutual housing and sharing with other interested parties locally and nationally the Association experience.

The Association's housing would be initiated and planned by and for the benefit of residents of NHS and other neighborhoods. Residents and potential residents of Association homes, and community leaders in partnership with City government representatives, financial, religious, philanthropic and business representatives and other housing professionals comprise the Association and direct the Association's activity. The specific purposes of the Association are as follows:

1) To develop within the City of Baltimore affordable, quality housing for members through the financial and personal involvement of resident members in concert with the other partners.

2) To serve as the permanent, long-term owner and manager of all Association housing, and to insure quality maintenance and upkeep of all Association homes and common areas.

3) To continue to meet the housing need of new potential residents through the ongoing production of additional Mutual homes through either new construction or the rehabilitation of vacant or neglected housing

4) To recruit and actively involve the entire Association partnership in overseeing all aspects of Association activity.

5) To encourage among resident members pride and involvement, and understanding of and compliance with the mutual self-help philosophy of the Association.

6) To operate in a publicly-accountable, competent and non-profit manner which insures housing for the maximum number of members to the highest possible quality and efficiency.

7) To carry out other activities deemed necessary to increase the availability of quality, permanent housing for members.

Neighborhood Housing Services of America
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2300 GREENMOUNT AVENUE — 2ND FLOOR
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Telephone 301/889-1451

March 25, 1982

TO: Workshop III Participants and the Board of Trustees

FROM: The Structure Committee Conveners

SUBJECT: Additional Material

The following are two additions to the material forwarded to you from the Structure Committee.

ADDITION 1

We propose that the section about staff be added to the Bylaws as part of Article IV, Board of Trustees. It would be added at the end of Article IV as a new Section 11.

Section 11. <u>Employees</u>

The Board of Trustees shall employ the Executive Director of the Association and shall authorize the employment of other employees as are needed to carry out the mission and responsibilities of the Association. The Executive Director shall select the other employees who shall be hired within job descriptions, salary ranges and hiring procedures adopted by the Board of Trustees.

ADDITION 2

The following section, outlining some responsibilities and powers of the Board of Trustees, was left out of our Policy Memorandum. Based upon our discussions within the Structure Committee, we had developed a list of what we felt would be some of the foremost responsibilities of the Board of Trustees. We pass them along for the first Board's guidance.

<u>Powers and Duties of the Board</u>

The powers of the Board shall include, but not be limited to the following:

A) To develop, own, and manage quality housing in the public and community interest.

B) To participate in the development, testing and replication of the mutual housing association model.

C) To set the rules of membership for the Association.

D) To accept or reject all applications for Class A, Class B, and Class D membership.

E) To terminate membership and occupancy rights for cause.

F) To hire, evaluate and terminate the staff director.

G) To promulgate such rules and regulations pertaining to use and occupancy of Association-owned housing as may be deemed proper and which are consistent with the Bylaws and Articles of Incorporation.

H) To select future development sites for additional housing.

I) To establish such committees as it deems necessary to assist in its conduct of the affairs of the Association.

J) To conduct all financial affairs of the Association.

[illegible]

[illegible]

[illegible]

[illegible]

FIRST: [illegible] ____________________ [illegible] ____________ [illegible]

SECOND: The name of the Corporation is [illegible] Inc. The Corporation shall commence business with the filing of these Articles, and shall have perpetual existence. The Corporation shall have its principal place of business in the City of Baltimore, Maryland. The resident agent of the Corporation is ______________, a Maryland resident, whose address is ____________________.

THIRD: The Corporation is organized exclusively for charitable, scientific, and educational purposes under Section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provisions of any future United States Internal Revenue Law). In furtherance of these purposes, the Corporation is organized to promote social welfare and lessen the burdens of government, [illegible] neighborhood tensions, and combat community deterioration by providing financial, technical, and management resources for the construction of new, or rehabilitation of vacant or neglected, dwelling units in one or more urban residential neighborhoods in or around the City of Baltimore, Maryland, and for the operation of these units on a non-profit, resident-sensitive basis that makes them available for occupancy by persons for whom home ownership may be infeasible or impractical; and to study, research and demonstrate the development, operation, and improvement of such housing opportunities, making information about the same broadly available to other organizations and the public, so that successful activities may be replicated throughout the State and Nation.

FOURTH: No part of the net earnings of the Corporation shall inure to the benefit of, or be distributable to its members, trustees, officers, or other private persons, except that the Corporation shall be authorized and empowered to pay reasonable compensation for services rendered. No substantial part of the activities of the Corporation shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the Corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of any candidate for public office.

Notwithstanding any other provision of these articles, the Corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law) or (b) by a Corporation, contributions to which are deductible under section 170(c)(2) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law).

FIFTH: The Corporation shall be managed by a Board of Trustees, all of whom shall be members of the Corporation, and whose number, election, removal, and tenure shall be established by the Bylaws. The following persons shall serve as Trustees until the first annual meeting of the Corporation and until their successors are elected and qualify:

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SIXTH: The Board of Trustees shall designate the initial membership of the Corporation; thereafter, the Bylaws shall prescribe the qualifications of membership.

SEVENTH: This Corporation shall have no authority to issue capital stock but shall derive its funds from fees, charges, assessments, dues and other contributions from its members, as well as donations, appropriations and contributions by governmental and non-governmental entities.

EIGHTH: Upon the dissolution, liquidation, or winding up of the Corporation, the Corporation shall, after paying or making provision for the payment of all the liabilities of the Corporation, dispose of all the assets of the Corporation exclusively for the purposes of the Corporation in such manner, or to such organization or organizations organized and operated exclusively for charitable, educational, or scientific purposes as shall at the time qualify as an exempt organization under section 501(c)(3) of the Internal Revenue Code of 1954 (or the corresponding provision of any future United States Internal Revenue Law), or to the Federal Government or to a state or local government, as the Corporation shall determine.

PROPOSED BYLAWS

FOR THE

MUTUAL HOUSING ASSOCIATION OF BALTIMORE

ARTICLE I

NAME AND LOCATION OF CORPORATION

The name of this corporation is the MUTUAL HOUSING ASSOCIATION OF BALTIMORE, INC. The principal office of the Association shall be located in Baltimore, Maryland.

ARTICLE II

MEMBERSHIP

Section 1. Composition and Size of the Association

A membership in the Association shall be granted to one or more persons, "members", who meet the qualifications for membership established in these By-laws or in policies adopted pursuant to these By-laws. Members are entitled to participate in all the affairs of the Association; however, only one ballot per membership may be cast on any issue to come before the Association as provided in Article III, Section 5 of these By-laws.

In all cases, the sum of Class A (pre-resident/resident) Memberships and Class B (waiting resident) Memberships shall be at least one more than Class C (community interest) Memberships.

Section 2. Classes of Membership

There shall be four classes of membership:

a. Class A (pre-resident/resident) Membership, which shall be granted to a person or persons who have attained the age of 18 years, have applied for residence in an Association owned dwelling unit, have received approval of their applications, and have executed a Membership Agreement.

b. Class B (waiting resident) Membership, which shall be granted to a person or persons who have attained the age of 18 years, have applied for such membership and have submitted membership dues established by the Board of Trustees. Each year the Board of Trustees shall establish the total number of Class B Memberships which will be granted for the coming year.

c. Class C (community interest) Membership, which shall be granted to a person who has attained the age of 18 years, and who is elected by the members for a three year term to provide expertise advice, cou sel, and support to the Association, and to assure that t operates in a publicly accountable, non-profit manner that maximizes the public benefit from Association ctivities Class C Members may inc ude community leaders, representatives of oca government, enders, professionals in real estate development and housing management, and other technical or financial resource persons.

d. Class D (associate) Membership, which shall be granted to a person or organization from whom the Association has accepted a financial contribution in an amount determined by the Board of Tru tees from time to time, or to a person who has otherwise demonstrated an interest in becoming involved in the affairs of the Association. Class D Members may not cast ballots.

ARTICLE III

MEETINGS OF THE ASSOCIATION

Section 1. Place of Meetings

Annual and special meetings of the Association shall be held at a place designated by the Board of Trustees.

Section 2. Meetings

a. Annual Meetings - The first annual meeting of the Association shall be held within one (1) year following the filing of the Articles of Incorporation. Thereafter, the annual meetings of the Association shall be held within ninety (90) days after the close of the Association's fiscal year. At each such meeting, the Association shall elect the entire Board of Trustees and new Class C (community interest) Members, if any, and may conduct such other business of the Association as may properly come before it.

During any annual meeting, and in accordance with rules duly adopted for the conduct of such meeting, any member may propose resolutions for the future guidance and direction of the Board of Trustees, the Officers, and the complex councils, and the conduct of the Association's business.

b. Special Meetings - It shall be the duty of the President to call a special meeting of the Association if directed by resolution of the Board of Trustees, or upon presentation of a petition signed by twenty (20) percent of the total number of the Class A, Class B, and Class C Memberships. The notice of any special

meeting shall state the time, place and agenda items for such a meeting. No business other than that specified in the notice of meeting shall be transacted at any special meeting.

During any special meeting, and in accordance with rules duly adopted for the conduct of such meeting, any member may propose resolutions directly related to the agenda items specified in the notice of meeting for the future guidance and direction of the Board of Trustees, the Officers, and the complex councils, and the conduct of the Association's business.

Section 3. <u>Notice of Meetings</u>

It shall be the duty of the Secretary to notify members by mail of each annual or special meeting. The notice will state the purpose, time and place where the meeting is to be held and shall be mailed at least ten (10) days, but not more than thirty (30) days prior to such a meeting.

Section 4. <u>Quorum</u>

At each annual or special meeting, the presence of persons holding at least thirty-five (35) percent of the memberships of the Association entitled to cast ballots (Class A, Class B, and Class C Memberships) shall constitute a quorum for the transaction of business.

Section 5. <u>Voting</u>

At each annual or special meeting, each Class A (pre-resident/resident) and Class B (waiting resident) Membership, whether held by one or more persons, and each Class C (community interest) Membership may cast one indivisible ballot on each issue to come before the meeting. Persons holding Class D (associate) Memberships have no ballot. Unless otherwise specified in these Bylaws, a majority of ballots cast on any issue during any such meeting at which a quorum is present shall determine the issue.

Section 6. <u>Proxies</u>

No proxy voting will be allowed.

Section 7. <u>Order of Business</u>

The order of business at each annual meeting of the Association shall be as follows:

(a) Roll call
(b) Proof of notice of meeting or waiver of notice
(c) Reading of minutes of preceding meeting
(d) Reports of Officers
(e) Reports of Committees
(f) Election of Class C (community interest) Members
(g) Election of Trustees
(h) Unfinished business
(i) New business

In the case of special meetings, items (a) through (d) shall be applicable and thereafter the agenda shall consist of the items specified in the notice of the meeting.

Section 8. Roberts' Rules

Unless these Bylaws specifically provide otherwise, Roberts' Rules of Order, latest revised edition, shall be the rules of parliamentary procedure of the Association.

ARTICLE IV

BOARD OF TRUSTEES

Section 1. Composition and Number

The business of the Association shall be directed by a Board of Trustees composed of 25 persons, all of whom shall be members of the Association. The Board of Trustees shall reflect the classes of membership of the Association and shall be apportioned as follows:

4 members representing neighborhoods where Association housing is located (Class C)
4 members representing Class B (waiting resident) Memberships
9 members representing Class A (pre-resident/resident) Memberships (including the chairpersons of complex councils)
2 members representing City government (Class C)
4 members representing the Baltimore business community (Class C)
2 at-large members from the Class C category of membership

Section 2. Powers

The Board of Trustees shall exercise all the powers of the Association, except those otherwise conferred or reserved by law, by the Articles of Incorporation, or by these Bylaws.

Section 3. Election and Term of Office

During his tenure as such, each Chairperson of each complex council of the Association shall be one of the members of the Board representing Class A Memberships on the Board of Trustees. All other Trustees shall be elected at each annual meeting of the Association. Trustees shall serve until the end of the meeting at which their successors shall have been elected.

Section 4. Successive Terms

There shall be no limitation on the number of terms a person may serve on the Board.

Section 5. Vacancies

The Board shall fill any vacancy on the Board resulting from the death, resignation or removal of any Trustee. Each such vacancy shall be filled by a person from the same class of membership as his predecessor. Each Trustee so elected shall serve until the end of the meeting at which his successor is elected.

Section 6. Removal of Trustees

Any Trustee may be removed by the affirmative vote of three-fourths (3/4s) of the other Trustees then serving.

Section 7. Compensation

No compensation shall be paid to Trustees for their services as Trustees, but the Board may provide for the reimbursement of reasonable expenses incurred by a Trustee.

Section 8. Meetings

The Board shall meet as often as necessary, but in any event, not less than six (6) times per year.

Section 9. Quorum and Manner of Acting

At each meeting of the Board, the presence of a majority of the Trustees then serving shall constitute a quorum for the conduct of business. Except as otherwise specifically provided in these Bylaws, the acts of a majority of the Trustees present at a meeting at which a quorum is present shall be the acts of the Board.

Section 10. Committees and Councils

The Board shall have standing and special committees as may be established by these Bylaws or by resolution adopted by the Board.

a. Executive Committee - There shall be an Executive Committee composed of the officers of the Association, the chairpersons of the standing committees, and such other Trustees appointed by the President with the approval of the Board, as shall be necessary to achieve representation of all membership classes on the Committee. During periods between scheduled Board meetings, the Executive Committee shall be empowered to conduct the ordinary and necessary business of the Association, and such other business as the Board may, from time to time, delegate to the Committee. The Committee shall report its actions to the Board at the Board's next meeting.

b. Finance Committee - There shall be a Finance Committee of the Board which shall perform such duties as may be established by resolution of the Board. The Committee shall be chaired by the Treasurer of the Association, and shall include the President of the Association, the chairpersons of the complex councils, and such additional members of the Association as may be appointed by the President with the approval of the Board.

c. Audit Committee - There shall be an Audit Committee of the Board which shall be responsible for meeting with, and receiving and discussing the reports of, the outside auditors of the Association. The Committee shall be composed of three Trustees who do not serve on the Finance Committee and who are appointed by the President with the approval of the Board.

d. Complex Councils - The Board shall establish a council for each Association complex, composed of persons residing in the Association complex and Class C (community interest) Members who reside in the neighborhood surrounding the complex, for the purpose of recommending to the Board policies related to the operation of the complex, and for such other purposes as the Board may, from time to time, determine.

ARTICLE V

OFFICERS

Section 1. Designation

The officers of the Association shall be the President, Vice President, the Secretary, the Treasurer, and such other officers as the Board may, from time to time, elect.

Section 2. Election of Officers

The officers of the Association shall be elected annually by the Board at the first meeting of the Board following the Annual Meeting of the Association from among the Trustees. Each officer shall hold office at the pleasure of the Board.

Section 3. Successive Terms

There shall be no limitation on the number of successive terms a Trustee may be an officer.

Section 4. Resignation and Removal of Officers

Any officer may resign office upon written notice to the Board. Upon resolution adopted by a majority of the Trustees, any officer may be removed and a successor elected at any meeting of the Board.

Section 5. President

The President shall preside at all meetings of the Board, of the Executive Committee, and of the Association. He shall see that all orders and resolutions of the Board are carried into effect. He shall have general superintendence of all other officers of the Association and shall see that their duties are

properly performed. The President shall provide such guidelines and direction as the Association employees may require. He shall, from time to time, report to the Board all matters within his knowledge that the interests of the Association may require to be brought to their notice.

Section 6. Vice-President

The Vice-President shall take the place of the President and perform the President's duties whenever the President shall be absent or unable to act, and such duties as the President or the Board may, from time to time, delegate. If neither the President nor the Vice-President is able to act, the Board may appoint some other member of the Board to do so on a interim basis.

Section 7. Secretary

The Secretary shall keep correct and complete minutes of all meetings of the Board, the record of memberships, and the minutes of all meetings of the Association. The Secretary shall serve all notices of meetings of the Association within the times established in these Bylaws. The Secretary shall attend to such correspondence as may be required and shall perform all duties incident to the office of Secretary of the Association.

Section 8. Treasurer

The Treasurer shall (a) have charge and custody of, and be responsible for, all funds and securities of the Association, and deposit all such funds in such banks, trust companies, or other depositori s as shall be selected in accordance with the provisions of the Bylaws; (b) receive, and give receipts for, monies due and payable to the Association from any source whatsoever; (c) keep correct and complete books and records of the Association's accounts and transactions in accordance with generally accepted accounting principles; (d) see that all expenditures are made in accordance with procedures duly established, from time to time, by the Association; (e) render financial statements to the Board when called upon to do so and a ful financial report at each Annual Meeting of the Association; (f) sign such documents as require the signature of the Treasurer; and (g) in general perform al duties incident to the office of Treasurer and such other duties as the President may, from time to time, assign. The Treasurer sha l give a bond for the faithful discharge of these duties, in such sum and with such sureties as the Board shall determine, unless the Board shall by resolution determine otherwise.

ARTICLE VI

INDEMNIFICATION

The Association shall indemnify an officer or Trustee, and may, by resolution of the Board of Trustees, indemnify an employee, against any and all liabilities and reasonable expenses actually and necessarily incurred or imposed in connection with any claim, action, suit, or proceeding (whether actual or threatened, brought by or in the right of the Association or otherwise, civil, criminal, administrative, or investigative, including appeals) to which the officer,

Trustee, or employee may be or is made a party, witness, or other participant, by reason of being or having been an officer, Trustee, or employee of the Association; provided, however, that there shall be no indemnification in relation to any matter as to which such person shall be adjudged, by a court of competent jurisdiction, to be guilty of a criminal offense, or to be liable to the Association for damages arising out of negligence or misconduct in the performance of a duty to the Association.

Amounts paid in indemnification of expenses and liabilities may include, but shall not be limited to, counsel fees and other fees, costs, and disbursements, and judgments, fines and penalties against, and (with specific Board approval) amounts paid in settlement by, such officer, Trustee, or employee. The Association may advance expenses to, or where appropriate may, at its expense, undertake the defense of, any officer, Trustee, or employee; provided, however, that such officer, Trustee, or employee shall first agree to repay or to reimburse such expense, if it should ultimately be determined that indemnification under this Article is not available.

This Article shall apply to claims, actions, suits or proceedings made or commenced after the adoption of these Bylaws, whether arising from acts or omissions to act occurring before or after adoption of these Bylaws.

Indemnification available under this Article shall not be deemed exclusive of any other rights to which an officer, Trustee, or employee may be entitled, under any law, other Bylaw, agreement, vote of the Board of Trustees, or otherwise; and shall not restrict the power of the Association to make any indemnification permitted by law. Indemnification available under this Article shall inure to the benefit of the heirs, executors, administrators, or other legal representatives of an officer, Trustee, or employee entitled to indemnification under the terms of this Article.

If any part of this Article shall be found to be invalid or ineffective, the validity and the effectiveness of the remaining parts shall not be affected. The Association may purchase such Officers and Trustees Liability and Corporate Reimbursement Insurance as the Board may deem appropriate to cover the Association's obligations and prerogatives hereunder.

ARTICLE VII

EQUAL OPPORTUNITY

The Association shall not engage in any discrimination prohibited by law in employment or the provisions of services.

ARTICLE VIII

FINANCIAL MANAGEMENT

Section 1. Fiscal Year

The fiscal year of the Association shall end on __(date)__ of each calendat year, or at such other time as may be fixed by resolution of the Board of Trustees.

Section 2. Books and Records

The books and records of the Association shall be available at the principal office of the Association for inspection at reasonable times by the members and by their duly authorized agents or attorneys.

At the close of each fiscal year, the books and records shall be audited by a Certified Public Accountant.

Section 3. Execution of Corporate Documents

The Board of Trustees may authorize by resolution any officer or agent of the Association to enter into any contract or execute and deliver any instrument in the name of and on behalf of the Association. All checks, drafts, or orders for the payment of money, notes, or other evidence of indebtedness issued in the name of the Association shall be signed by such persons at least two in number and in such manner as shall from time to time be determined by resolution of the Board of Trustees. In the absence of such determination by the Board of Trustees, such instrument shall be signed by the Treasurer or Assistant Treasurer, if any, and countersigned by the President or Vice President of the Association.

ARTICLE IX

AMENDMENTS

These Bylaws may be altered, amended, or repealed, and new Bylaws may be adopted by a two-third (2/3) vote of the Trustees, or a majority of the ballots cast at an annual or special meeting of the Association.

Mr. VENTO. Thank you, Mr. Whiteside. We appreciate your testimony. It is very comprehensive in nature. I appreciate you highlighting it. I think that most members have shown a real interest in the Neighborhood Reinvestment Corp. in the past. It has been one of the few programs that has not been eliminated as we go forth. It has been certainly limited in terms of its function but it shows a surprising ability to keep building on the relationships that are created within the urban centers.

Let me first direct some questions to the other witnesses today. We may have to have you act like a referee, Mr. Whiteside in this particular context. I am sure we understand that the role and the goals of both the private and public sector here are, of course, to provide financing for housing.

So, the end result, I expect, will be when we get done, more funds available or hopefully some funds available within the context of our economy. It is a real pleasure to welcome Mr. Waldo. He and I served on a panel earlier this year before the builders, talking about some of the same concerns that he raises today.

So, it is a real pleasure. Also it is a pleasure to see Mr. Taylor, with his distinguished role working with GNMA in many capacities. Mr. Waldo, in your statement, you point out that you see no reason to doubt the adequacies or inadequacies of a $38.4 billion limit on GNMA program. Does that mean you believe the level will be sufficient to support a $35 billion level for FHA, or does it simply reflect your belief that GNMA programs are not desirable?

Mr. WALDO. My statement reflects the belief that that is the level of business that will actually be available. In 1981 the FHA initiated somewhere around $12 billion in loans. VA did a similar

amount. The private industry initiated more loans than the VA and FHA combined. Our level last year was somewhere around $1 billion.

So, it would appear that a $35 billion authorization level for the FHA would be adequate and that the FHA business, combined with the VA business, should not exceed the $38.4 billion that has been authorized for GNMA. I do not have from the top of my head the number of new GNMA issues that came out in 1981, but I am quite confident that it was nowhere near the $38 billion.

I might just emphasize, Mr. Chairman, that what we are trying to point out is that the private sector has a tremendous role to play. We have not really had a chance to play that in the latter few years because there has been no structure for a conventional mortgage-backed security. There just isn't any opportunity to get a publicly offered mortgage backed security out into the marketplace, because of registration requirements, because of income tax concerns, as to what happens to all of the parties who are involved, because of investor concerns as to whether they really have the authority to buy and hold these things, once we get the product issued.

All of this limits the amount of conventional backed securities that can come to market. If there is a limited supply of the product in the marketplace, there is no opportunity for investors to develop any kind of investor familiarity so you can develop a freewheeling and faster moving market.

I think the FNMA conventional security program that it has started is an excellent one. I think starting with both FNMA and FHLMC is a tremendous way to go because both of these institutions have investors familiarity. People have bought FNMA debentures for years. They know who FNMA is. Even thought FNMA is having problems right now, with a negative income, that really isn't perceived, I do not think, in the investments community as a real drawback.

FHLMC, since 1971 or so, has been issuing its participation certificates so everybody knows FHLMC, they know their reputation, they know their ability.

So, I think, this is a great place to start with conventional mortgage-backed securities. We need more than that because FNMA and FHLMC have limitations on the kind of loans they can buy. I think there will be room in the marketplace for many other conduit mortgage-backed certificate type organizations, whether it is operated by investment bankers, or whether it is operated by companies such as ours that have an interest in seeing that these things get done.

We do need the mechanism. We do need legislation that will permit that to happen. Once that does happen, then I think that the market—the natural force of the market are going to gravitate toward the conventional business. We have seen that happen. We don't consider the FHA a real competitor of ours. We started when the FHA was the only game in town. And year by year and month by month we have gained on them.

To this, I mean right at 1981, which is as tough a market as you ll find, we have initiated more than the FHA and VA combined.

So, that is not a problem. But, our problem is being able to package these conventional loans and getting them into the marketplace, so we have the same access to the market as the GNMA has. I am sorry, you asked a simple question and I kind of gave you a drink from a fire hydrant, but I do think those remarks are germane.

Mr. VENTO. I think it is good to have them on record if they are not reflected in your other remarks.

The point of course is that Congress has been, I think, ready and willing and has created the opportunity for your entry and has facilitated that participation. I think that there is probably a positive attitude, an open mind with regard to that.

The only question is, of course, insofar as the role of the FHA and the other facilities that we have, within that context. I mean, I think it is important, as I said when I served on the panel with you in terms of the countercyclical nature of FHA, of VA, in terms of what they do. I do not think that necessarily the private sector can answer that. Maybe they will in the future. We certainly want to keep FHA and VA present in that particular context.

Let me just go back now, if I could, to Mr. Taylor with a question. Do you believe, Mr. Taylor, that the continued presence of GNMA on the mortgage-backed securities will inhibit the development of a viable conventional mortgage-backed securities program?

In other words, if we keep you healthy and viable, at whatever level of activity. I take Mr. Waldo's statement is that he just doesn't believe that there is going to be more than $38 billion or whatever the figure is that he testified to, of activity. So, you might want to respond to that and what type of problems that may create for you, if any. And the presence of the mortgage-backed securities program, its impact on the private or conventional market program?

Mr. TAYLOR. Well, Mr. Vento, let me say that I am now speaking as someone with the perspective of the private industry. I never have understood, and now that I am in the private sector I understand even less, the position taken by private mortgage insurance companies.

Looking from our point of view, we see a need for both. We see a need for a conventional mortgage-backed security. Frankly, Mr. Vento, one of the reasons I was hired by Bankers Mortgage Corp. was to develop a conventional mortgage-backed securities program for them.

But, at the same time, I believe we need the FHA and GNMA programs. You pointed out that FHA's limitation for fiscal year 1983 has been proposed at $35 billion. We may or may not use that amount of authority. But, remember that the Veterans Administration has a mortgage guarantee program on which there is no ceiling. The Government National Mortgage Association's mortgage-backed securities program provides the only viable outlet for these loans in the secondary mortgage market.

As I pointed out in my testimony, there are serious questions about the ability of the only other major market participant in the FHA, VA market, the Federal National Mortgage Association; to expand its role to counter any reduced GNMA activity.

As I also explained in my testimony, Mr. Vento, one of the reasons why the private sector needs a substantial level of commitment authority over and above the amount of securities issued each year, is to give us the ability to hedge our positions, and thus allow us to be able to go out and enter into commitments to buy loans in significant volumes.

My concern is, Mr. Vento, if this commitment level is reduced, so that those private financial institutions, such as mortgage bankers, that make up the 1,100 security issuers are not able to obtain all of the commitment authority they need, they will cut back on their FHA and VA activity and as a result, this will seriously impact on the ability of this market to recover from the depths of the depression which it finds itself in today.

Mr. VENTO. Very good. I suspect, Mr. Waldo, you might have a difference of opinion there. I see an expressive nod, is that right?

Mr. WALDO. I am sure we could carry on an argument for some time, but really, I think that Mr. Taylor makes a very good point and I wouldn't debate that.

Mr. VENTO. We will quit while we are ahead then?

Mr. WALDO. I do not say we have agreement. I think he made a very good point. All of the players in the mortgage market do need to have flexibility in which to operate. I think one of the ways to give all of the players the maximum flexibility is to create this structure for a conventional mortgage-backed security. I think many of the other problems and many of the other concerns that people have about the impact of GNMA, not only crowding out conventional mortgage-backed securities or crowding out other government bargaining, will disappear simply because I think the private sector can do a heck of a lot better job in this area than the Government sector, and I think we will show it.

Mr. VENTO. Nobody is being crowded out?

Mr. WALDO. Nobody is being crowded.

Mr. VENTO. There is plenty of room, I feel that we can put no limitations. I have got a dilemma here. You heard the bells ring. Obviously my colleagues had a varietiy of commitments. I want to ask a number of brief questions of Mr. Waldo, and if we could get brief answers and then turn to Mr. Whiteside, I would appreciate it if I can get out of here so I can make my vote.

If the chairman shows up he may prevail upon you while he asks some questions. Your statement, Mr. Waldo, is that you believe that 9½ percent of the minumum rates are low. What would you suggest would be the proposal in terms of that program?

Mr. WALDO. I do not feel as strongly about the 9½-percent interest rate. I think that it seems a little low. But I suspect the actual level of interest rate would be something that would be determined by the regular congressional processes.

My major concern with H.R. 5731 is that it focuses the emphasis on insurance, on the FHA. I do not think that ought to be. I think that the private sector should be recognized.

Mr. VENTO. Let me ask this next question. Does that mean that tl private mortgage insurance companies want to compete with ıA and you are competing at the same level?

Mr. WALDO. We will insure any loan that lenders make. We have to insure like others because that is what our customers need and others are doing that.

Mr. VENTO. You are not differentiating. Let me move on to Mr. Whiteside. I do appreciate your attendance here today. One of the programs that you pointed out correctly, Mr. Whiteside, that we are interested in is the mutual housing associations.

I appreciate you highlighting that in your testimony. We are somewhat concerned about the status of that program in terms of what its viability is. If we think we have something successful in Baltimore that is working, the question is why aren't we then replicating it or increasing the number of options that we have with regard to pilot programs in other areas.

What is the form of subsidy or Government assistance used there?

Mr. WHITESIDE. It is a front-end subsidy contemplated as a Federal grant. We are putting together a consortium of foundations for the $2½ million capital grant necessary for the first 60 units of construction in Baltimore.

Mr. VENTO. There is some confusion here about this.

In other words, don't you then do that, the same thing in other areas with regard to philanthropic type of activity to fund mutual housing if you chose to?

Mr. WHITESIDE. I think there is a limit to what can be done in this area philanthropically. I think on a demonstration basis, that we will be able to pull in the necessary support. But I see what we are doing here as creating a demonstration to be watched by the Congress for a potential future publicly——

Mr. VENTO. Haven't you already been able to demonstrate there are a lot of moneys to be saved in terms of this mutual housing effort?

Mr. WHITESIDE. We are not operational yet, no, sir. We just about have the corporation organized. The initial group of——

Mr. VENTO. This exists in other areas, does it not? We know in other jurisdictions, in other countries they use similar concepts, have they not?

Mr. WHITESIDE. Yes, they do. What we have done is to adapt that concept to American institutions, and really tailor the model to the community level of activity in the NHS neighborhood.

So, I wouldn't want to—we are very hopeful and confident, but I wouldn't want to predict——

Mr. VENTO. Shouldn't we really be doing this more than in just Baltimore? Shouldn't we be doing this in other areas? It is an idea that has a tremendous potential to help to improve housing, doesn't it, in your judgment or not?

Mr. WHITESIDE. It certainly does. It is our hope to demonstrate it in about three other locations, so that we can get different housing stocks, different sections of the country involved. And some——

Mr. VENTO. But you can't spend your energy on raising money. I mean, it is fine if you can raise money, if someone will step forward and donate. But you can't realistically be able to expect to raise the amount of money you are doing in Baltimore and replicate that in Minneapolis, St. Paul, Seattle, Houston or wherever it seemed to be justified.

You can't hope to raise that kind of money, can you?

Mr. WHITESIDE. I do not know any alternative but to try. And to do as much as we can. Because clearly, in the level of authorization we are talking about here, there is not the magnitude of funds to deal with additional demonstrations.

Mr. VENTO. Have you put a proposal together asking for more demonstration funds from the administration and OMB? Did you put any in or not?

Mr. WHITESIDE. We had a $10 million request for three additional demonstrations in our fiscal year 1983 proposal to OMB, which was not acted on.

Mr. VENTO. There was no positive response so you are left without any. But doesn't this offer great hope in terms of meeting the housing needs of people in these urban areas?

Mr. WHITESIDE. I think it is the best hope we have uncovered for beginning to deal with rental resources in the median income and below part of the market.

Mr. VENTO. Some people might not understand and I have some difficulty, the difference between a cooperative and condominium. What is the difference? How is it specifically different?

Mr. WHITESIDE. This is not a cooperative or a condominium. It is a mutual association. The association is the owner of the property. The association members rent from the association. They do not participate in any equity growth. The equity growth belongs to the association. You achieve some of the participative and pride aspects of home ownership through involvement in decisionmaking and participation on the board and so on. The design is to have a mutual housing association as a continuous producer that over a period of years will be able to utilize self-generated capital through the equity buildup.

Mr. VENTO. Well, this is an extremely important thing, I think. We find so many people unable to get into conventional type of mortgage because of interest rates and other factors. I think we should assist people to achieve a little degree of that traditional value, the feeling of homeownership, a stake in the property in an urban area. That seems to be very important. I hope we can improve on that. Mr. Waldo, did you have a comment?

Mr. WALDO. Our industry and my company particularly are familiar with the work that Mr. Whiteside's organization is doing around the country, I would have to agree with you that this is an excellent program for getting marginal credit risks into good housing. And of course, the level of expertise varies from community to community. There are some good ones and some not so good.

But, on the whole, I think it is an excellent program and it certainly deserves Congress support.

Mr. VENTO. We ought to be looking at setting up a wider demonstration base so we can build the support and understanding. Neighborhood Reinvestment Corp. is perfect because it deals with those technical aspects and deals with tieing together the secondary market and other sources of financing and has done so successfully, in traditional and nontraditional programs. That is the encouraging aspect.

So, neighborhood reinvestment program has successfully spun off ıd continues to be in the vanguard in terms of urban settings. We

desperately need that. I hope both of you, Mr. Taylor and Mr. Waldo and others interested in housing are paying attention to this particular program. We need to put some money into this mutual housing concept. I think that is a good option that should be given an adequate demonstration to see its workability within the present context.

[Submitted for inclusion at this point is the following material: A letter, dated March 30, 1982, from Federal Home Loan Mortgage Corporation President Philip R. Brinkerhoff with the corporation's views on sections 512 and 513 of H.R. 5731; and the questions of Chairman Gonzalez to witnesses Maxwell, Taylor, and Waldo, with the responses of the witnesses. The material follows:]

The Mortgage Corporation

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March 30, 1982

The Honorable Henry B. Gonzalez
Chairman, Subcommittee on Housing
and Community Development
2129 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

The Federal Home Loan Mortgage Corporation (the "Mortgage Corporation") is pleased to have this opportunity to express views on Sections 512 and 513 of H.R. 5731 for the hearing record. The corporation appreciates the deep concern for the state of the nation's housing that you and the other members of the subcommittee have demonstrated. We share this concern.

To date, the Mortgage Corporation has brought more than $30 billion to home mortgage lending in America. We look forward to providing continued service to the mortgage marketplace, and offer these comments with that goal in mind.

Section 512(b) <u>Limitations on Participation Agreements</u>

The relationship of the current statutory mortgage limits to the purchase of participation interests has been unclear. We understand that this amendment is intended to clarify Congressional intent on this matter. After FNMA's November announcement that the maximum limits applied to the participation interest rather than to the amount of the original loan, we met with your Subcommittee staff to obtain their interpretation of existing statutes. We understood the Subcommittee staff position to be that the maximum mortgage purchase limits under existing law are limits on the total principal balance of the loan, not merely on the amount of the participation interest to be purchased.

We agreed to respect that interpretation until the Congress could review and clarify this matter. As a result, the Mortgage Corporation has maintained its policy on this point which is in a manner consistent with the Subcommittee staff's interpretation.

However, the discrepancy between the Mortgage Corporation's policy and FNMA's has put us at a competitive disadvantage in offering services to lenders. The FNMA policy enables lenders to gain additional liquidity because it makes virtually every loan in a lender's portfolio eligible for at least partial purchase by FNMA. Additional liquidity is especially important in high cost areas where a large share of the loans being originated exceed the statutory limitations in the corporations' charter acts.

As you know, the Mortgage Corporation has supported legislation before this committee in the past to raise or eliminate statutory loan purchase limitations. H.R. 4787, the Mortgage Corporation's recapitalization bill, currently pending before the Committee, would place responsibility for setting loan limits in the corporation's Board of Directors. This approach is consistent with our objective of privatization and would permit us to respond to lenders' needs as they develop without the delay involved in revisions to statutory limits.

Liberalized limits on participations would permit us to provide lenders with needed liquidity without ignoring the low and middle income households the Subcommittee wants to ensure will be served. Nearly all of our purchase participations are 85-95 percent of the total principal balance of the loan. The number of very high priced houses for which participations are purchased should always be low because lenders do not want to keep large, illiquid residuals in their portfolios. In any event, the Mortgage Corporation has no intention of abandoning its traditional role in providing funds for low and middle income families.

Section 513(b) Purchase of Second Mortgages

Expanding the Mortgage Corporation's loan purchase authority to include second mortgages intended to finance the purchase of a home is an important change in view of the National Association of Realtors' estimates that one third of the houses purchased in the United States last year involved secondary financing. The Mortgage Corporation strongly supports this expansion of authority.

For the past two years, we have established our own loan limits for second mortgages purchased under our pilot Home Improvement Loan (HIL) program. We have not abused this authority to adjust our limits to reflect market developments and feel that such flexibility is essential to the operation of a responsive secondary market. Congress intended in its 1978 authorization of the HIL program (Sec. 1702 of Public Law 95-630) that its loan limits be linked to the limits imposed on Federal savings and loan associations by the Federal Home Loan Bank Board (FHLBB).

However, following Congressional intent in the Financial Institutions' Deregulation Monetary Control Act of 1980, the FHLBB has removed all dollar limitations, instead relating lending limits to maximum loan-to-value ratios. The Mortgage Corporation's current HIL limits of $15,000, $40,000 and $60,000 reflect our policy rather than FHLBB regulations. Because our view is that the real test of soundness which should govern the extent of our participation is the total financing to value ratio, we are now reviewing the possibility of increasing the HIL limits.

We recently reviewed our HIL portfolio and surveyed members of our HIL advisory group to obtain information regarding the volume and characteristics of HILs and other seconds. A copy of our survey summary has been provided to the Subcommittee staff. A widespread concern among lenders, which we share, is that restricting the Mortgage Corporation in the areas of total financing to value and loan amount would put an additional burden on an industry which is already strapped for loanable funds Statutory limits quickly become out-of-date and would impede the Mortgage Corporation's ability to bring funds from capital surplus to capital deficit areas. In addition, the restrictions in Section 513 could force some borrowers away from traditional lenders, which sell to FNMA and the Mortgage Corporation.

The statutory restriction on the use of HIL loan proceeds only for home improvements has already prevented us from responding to market demands and providing lenders with needed liquidity. Borrowers of home improvement loans almost always intend to finance both eligible improvements and some personal need, such as education or a vacation, with the proceeds. As a result, the HIL program has never had significant usage by lenders, who cite the statutory restriction on the use of the loan proceeds as the chief impediment. Further restrictions on this program may result in so little use as to make this pilot program infeasible from a cost standpoint.

Not only is the language imposing loan limits for seconds inconsistent with our current authority to establish our own limits on HILs, it is very restrictive in view of the authority extended for purchase-money seconds. Limiting these seconds, which lenders say are usually higher than the restricted-use HILs, would further inhibit financing residential sales today.

In addition to the dollar limits, a maximum loan-to-value ratio of 80 percent of the "appraised value" of the dwelling has been proposed. This is more restrictive than current regulatory authority and industry practice. While we agree that a ratio of total financing to value is appropriate for prudent lending, we feel that it should not be set by statute.

For example, our current Charter Act does not have a maximum loan-to-value ratio for first lien loans; rather, it requires mortgage insurance for loans with a ratio higher than 80 percent. In our view, the applicable total financing-to-value requirement for second mortgages should be the same as the ratio for our first lien program.

The Mortgage Corporation also urges that the term "appraisal" be deleted from the Bill. This term is not used in the loan-to-value provision of our Charter Act governing first mortgages (Section 305(a)(2)). Moreover, appraisals can be expensive for the borrower, and are often unnecessary for smaller loans. The Mortgage Corporation has developed, and is using, effective streamlined techniques for estimating value in its HIL program, thereby avoiding the expense of a full appraisal. We hope you will leave the method of estimating value to our discretion, in that it means savings for consumers.

Similarly, we oppose a statutory requirement that restricts second mortgages to residences which are owner-occupied. As circumstances have made it increasingly difficult both for renter households to afford homeownership and for owners to sell residences upon transfer, we do not want to preclude access to financing which increases the supply of standard rental housing. Although the Mortgage Corporation currently does not purchase mortgages on such non-owner-occupied rental property, we want to retain the flexibility to respond to market developments and the potential for an acute need for liquidity.

Finally, we would like to offer some technical comments on the language proposed in Sections 512 and 513. They are as follows:

1. Partial Financing: Section 513(a) of the bill would make an amendment to the Federal National Mortgage Association Act (the FNMA Charter Act) to give FNMA the authority to purchase second mortgages on a residence the improvement of which was financed in whole or in part by such mortgage. The Mortgage Corporation's Charter Act does not now contain the "in the whole or in part" language. Rather, our Charter Act permits the purchase only of a loan "the proceeds of which are intended to finance the rehabilitation", etc., of property (Section 302(h)).

In essence, we believe that the language setting forth the FNMA and the Mortgage Corporation authority in this regard should be the same. In order to maintain parity, Section 302(h) of our Charter Act should be amended by inserting "in whole or in part" after "finance."

2. "Seconds" vs. More Subordinate Liens: Section 513(b)(1) of the bill refers to financing, in a "secondary" manner, the purchase of a home. This provision could be read to preclude the purchase of third or fourth mortgages, which are becoming frequent vehicles for home finance. If this provision is intended to limit the Mortgage Corporation to purchase of seconds only, we would suggest that risk management is adequately addressed by the maximum total financing-to-value ratio, rather than whether the junior lien is in a second position, third, or otherwise. If the limitation is not intended, we suggest that "junior" or "subordinate" might be a more appropriate term.

3. Inconsistent Limits: Section 513(b)(2) of the bill would impose a $60,000 limit on a 2-4 family residence for the Mortgage Corporation. By contrast, Section 513(a) would impose a $60,000 limit on a 2-family residence for FNMA. Again, we oppose any limits here, but any limits which may be imposed should be consistent for both FNMA and the Mortgage Corporation.

In conclusion, Mr. Chairman, we at the Mortgage Corporation look forward to working with you to further serve the housing needs of the nation's citizens.

Sincerely,

Phil

Philip R. Brinkerhoff

[The following written questions were submitted by Chairman Gonzalez to the panelists, Mr. Maxwell, Mr. Taylor, and Mr. Waldo, and appear with their responses. Also included is a response from Mr. Maxwell to a question posed by Congressman Vento earlier in the hearing.]

QUESTIONS SUBMITTED TO MR. MAXWELL

Question 1. You mentioned that Fannie Mae is completing design of a mortgage instrument which combines the features of a graduated payment and adjustable rate mortgage. It is my understanding that the Secretary of HUD's approval is necessary in order for Fannie Mae to undertake new programs such as this one. Will you be submitting this proposal to the HUD Secretary in the near future?

Answer. FNMA's purchase of mortgages combining adjustable rate mortgages with graduated payment features began shortly after the announcement of our adjustable rate program in July 1981. Initially, these graduated payment adjustable rate loans were purchased under specially negotiated commitments. We recently announced three standard graduated payment plans which supplement the eight regular adjustable rate loan plans begun last July. FNMA thus provides a market for a variety of these loans, which we believe are a needed response to the demand for affordability under current economic conditions. The graduated payment feature of our adjustable rate loans also provides a greater degree of certainty in the borrower's mortgage payments during the early years of the loan.

These loans are purchased under FNMA's 1-4 family conventional loan program, which was approved by the Secretary of HUD under section 302(b)(2) of the FNMA Charter Act. We do not consider our purchase of conventional mortgages with a graduated payment feature to be a new "program" requiring the prior approval of the Secretary of HUD under the HUD regulations governing FNMA's operations.

Question 2. You briefly note in your testimony a number of innovative approaches that Fannie Mae has taken to fund housing while at the same time improve your financial position. Could you provide for the Committee some greater detail as to these new programs, and how their level of activities compares with the other more traditional purchase programs offered by Fannie Mae?

Answer. During 1981, FNMA introduced the following new purchase plans and other secondary market initiatives:

1. Adjustable rate mortgages (ARM's).—Are home loans on which the interest rate is adjusted periodically according to a selected interest rate index such as the rate on a specified Government security. FNMA currently purchases ARM's under eight different plans. Table A shows the most important features of these plans.

Recently, FNMA has developed three variations of these adjustable rate loans which incorporate graduated payment features. Under the FNMA graduated payment adjustable rate loan plans, the borrower's initial monthly payment is based on a formula that limits each annual payment increase to 7½ percent during the initial period for which the interest rate is fixed. This permits a comparatively low initial payment and results in a scheduled increase in the unpaid principal balance until the initial interest rate is changed. At the time of the first change in interest rate the borrower can elect to again limit monthly payment increases to 7½ percent per year during the second adjustment period, subject to an overall limit on unpaid principal of 125 percent of the original loan amount. This affords the borrower an additional element of protection against severe monthly payment increases if interest rates increase when the initial note rate is subject to change.

FNMA also purchases ARM's (including graduated payment ARM's) that have different loan characteristics from those shown on table A, under special negotiated transactions. Through March 31, 1982, FNMA had issued $3.2 billion of commitments to purchase ARM's and had purchased $400 million of such mortgages (including mortgages purchased under special negotiated transactions). We are the only secondary market institution actually providing a market for the many varieties of ARM's, and have thus played a pivotal role in permitting builders to move inventories of unsold homes and enabling homeowners to sell their homes.

2. Conventional mortgage-backed securities.—Are passthrough trust certificates issued by FNMA that represent an interest in a pool of conventional mortgages. FNMA guarantees timely payment of scheduled monthly installments of principal and interest to certificate holders. The first public underwritten offering of such securities ($250.9 million) was made in December 1981 and a second public offering (approximately $250 million) will be closed on April 27, 1982. In addition, through 31, 1982, FNMA has exchanged $2.5 billion in guaranteed trust certificates

for conventional mortgages previously held by savings and loan associations. FNMA has made commitments beginning March 17, 1982, to open this plan to new loan production. Lenders are now able to obtain forward commitments to deliver loans originated at current interest rates for these securities. We believe that this security will be one of the principal sources of liquidity for the home mortgage market.

TABLE A.—SUMMARY OF FNMA'S STANDARD ARM PLANS

Plan	Interest rate index	Adjustment			
		Interest rate period	Payment period	Maximum interest rate	Maximum payment
1	6-month Treasury bills, weekly auction average rate.	6 months	6 months	None	7½ percent.
2	Same as plan 1	6 months	3 years	None	None.
3	1-year Treasury securities (adjusted constant maturities), weekly average yield.	1 year	1 year	None	7½ percent.
4	3-year Treasury securities (adjusted constant maturities), weekly average yield.	30 months	30 months	None	18¾ percent.
5	Same as plan 4	30 months	30 months	5 percent	None.
6	5-year Treasury securities (adjusted constant maturities), weekly average yield.	5 years	5 years	None	None.
7	FHLBB average contract rate, purchase of previously occupied homes.	1 year	1 year	None	None.
8	Same as plan 7	1 year	1 year	2 percent	None.

3. Second mortgages.—On September 10, 1981, the Secretary of HUD approved FNMA's purchase of second mortgage loans. These loans are purchase money, home improvement and home equity loans. FNMA generally limits its purchases of second mortgages to those in which the unpaid principal balance plus the unpaid principal balance of the first mortgage does not exceed 80 percent of the value of the mortgaged property, in amounts up to the statutory limit of $107,000. Through March 31, 1982, FNMA has issued $347 million of mandatory commitments to purchase second mortgage participations and has purchased $275 million of such mortgages. The average outstanding balance of the second mortgages in which FNMA has purchased interests is $20,600.

4. Participation purchases.—In June 1981, FNMA expanded a special program for the purchase of participations in urban area loans into a nationwide participation purchase program. Under the program, FNMA purchases a 50 to 95 percent interest in a pool of loans. This program utilizes a standardized participation agreement, streamlined underwriting and purchase procedures and simplified accounting reports. The program offers rapid liquidity to lenders and has been particularly well received by savings and loan associations, most of whom have broad experience in the purchase and sale of participations. This program is a major part of our efforts to increase the volume of business with thrift institutions.

As of March 31, 1982, FNMA has purchased $935 million of participations in fixed rate first mortgage loans. (Participations in ARMs and second mortgages are included in the purchase totals shown for those instruments in paragraphs 1 and 3 above.)

5. Buydown mortgages.—In 1981 FNMA began purchasing "buydown mortgages," under which a lump sum is paid at the time of settlement (by the builder, home seller or a member of the buyer's family) to reduce the borrower's monthly installment (and effective rate of interest) for a period of one to ten years. This initiative directly responds to the difficulty borrowers experience in qualifying for needed financing and has proven to be very popular with home buyers and the real estate industry alike. Buydowns can be used with both fixed rate and adjustable rate mortgages.

6. "Resale/refinance" mortgages.—FNMA Resale/Refinance plan makes it possible for homeowners who are FNMA mortgagors to sell their homes or use their equity to make needed improvements and repairs. This plan is expected to improve the yield on older, relatively low yielding loans in our portfolio. The homeowner or home purchaser is offered a conventional loan with a "blended" rate which is below market. This innovative approach has been very attractive to those wishing to refinance their existing loans or finance the sale of their homes. As of March 31, 1982, FNMA has purchased $1.4 billion in new loans that replaced $684 million in portfolio loans.

7. *Mandatory commitments.*—FNMA introduced mandatory delivery commitments in 1981 as an alternative to the exclusive reliance on optional delivery commitments. Optional commitments tend to be expensive since they must include an "insurance premium" against the risk of rising interest rates. Mandatory commitments cost the lender less and enable FNMA to better match the yield it requires with its cost of funds. We will continue to offer optional commitments but we expect the greater share of future loan deliveries to be made against mandatory commitments.

Table B shows commitments and purchases of ARMs (including graduated payment instruments), second mortgages and other new activity compared with the activity under FNMA's traditional purchase programs.

TABLE B.—RECENT FNMA COMMITMENT AND PURCHASE ACTIVITY

[In millions]

FNMA activity	Commitments		Purchases	
	1981	1982 [1]	1981	1982 [1]
ARM's	$1,250	$1,950	$106	$335
Second mortgage participations	213	134	176	99
First mortgage participations	752	248	717	218
Resale/refinance	1,722	323	1,146	270
Conventional whole loans (mandatory commitments)	540	316	367	335
FHA/VA whole loans (mandatory commitments)	595	131	563	120
Conventional whole loans (optional commitments) [2]	1,863	62	1,314	75
FHA/VA whole loans (optional commitments) [2]	2,376	96	1,723	53
Other negotiated transactions	20	65	1	47
Total	9,331	3,325	6,113	1,552

[1] January to Mar. 31, 1982

[2] Represents activity under FNMA's traditional purchase programs.

Question 3. I think we ought to make clear for the record just what the disagreement has been between the Committee and Fannie Mae with regard to issue of how the statutory mortgage limits apply to the purchase of a participation interest in a mortgage.

I think it ought to be made clear that the Congress has never explicitly considered how the limits should apply to participations. At the time the limits were put into place, Fannie Mae was only purchasing whole loans. I have been on this Committee for 20 years, and to my knowledge this issue was never addressed.

Moreover, the possible interpretation you have suggested would represent a rather dramatic shift in the policy that the Congress has always adopted towards Fannie Mae. So for these reasons I believe it is important that the Congress squarely consider this issue and resolve it. I am glad to hear from you that you agree with me on that.

However, we do seem to disagree as to the substance on this issue. In the past, the Congress has imposed mortgage purchase limits on Fannie Mae on the basis that since Fannie Mae receives considerable Federal benefits, it should direct its activities towards supporting the middle segment of the housing market. Why should a Federally-associated entity devote its resources towards supporting $300,000 homes?

Answer. We agree with the Subcommittee that this point was never discussed or considered explicitly in the early Congressional debate over FNMA's authority to buy conventional mortgages and thus may be subject to different interpretations. As we advised the Subcommittee, in deference to the Subcommittee's view of this provision, we will not purchase participation interests in loans that exceed our statutory limit until the Congress acts or declines to act on this matter.

In our view, there are sound business and policy arguments supporting the complete removal of all mortgage limitations.

Whether or not the existing loan limitations provision is retained, we do not consider its application to the portion FNMA purchases on a participation basis to result in a dramatic shift of policy. FNMA will in any event continue to support low and moderate income housing and FHA/VA mortgages. The removal of mortgages limits or the authority to purchase participation interests of up to the statutory amounts would permit FNMA to serve a greater portion of the market in higher cost areas, but would not do so at the expense of the lower end of the market where the greatest share of FNMA's business lies. Since most loan participation sales to FNMA result in FNMA purchasing a 90 percent or greater interest in the relat[illegible]

loan, the impact of these limitations, while significant in high cost markets, is not dramatic from a national perspective and will not affect FNMA's ability to support the market as a whole. Indeed, we believe the increased earnings produced by a complete removal of the loan limits would improve FNMA's capacity to purchase loans of all amounts.

We believe that it is of the utmost importance for FNMA to maxmize its purchases of mortgages at current market yields in order to increase the average net yield on our mortgage portfolio. As of the end of 1981 that average net yield was 9.85 percent while our average cost of debt was 11.42 percent. Our purchase activity over the year permitted us to raise the average portfolio yield by 61 basis points, from 9.24 percent. The negative yield on FNMA's portfolio resulted in 1981 net losses in excess of $190 million. Our responsibility to the home buying public looking for sources of housing finance as well as to FNMA's shareholders and creditors make it imperative that we take all possible steps to return the portfolio to a positive yield situation as soon as possible.

We also believe the data clearly support the view that increasing this potential source of mortgages available for purchase does not imply any reduction whatsoever in FNMA's support of the lower-priced portion of the housing market. Figures made available by the National Association of realtors show that the median price of homes sold in November 1981 was $66,200, that 54.6 percent of November home sales were at prices below $70,000 and that almost one-third of such sales were below $50,000. Sales figures for 1980 show a similar distribution. As a result of this market distribution, FNMA has a strong economic incentive to support the lower portion of the market very actively. We are, of course, committed as a matter of statute and policy to support of the lower- and moderate-income housing market.

Question 4. You indicate that no restrictions should be placed on Fannie Mae's second mortgage purchase activities in order to provide the most support to savings and loans and other primary lenders. It is my impression that most of the second mortgage lending is done by finance companies. Could you provide the Committee with some additional data on the type of lending institutions which have sold second mortgages to Fannie Mae? Also, do you have any data as to the extent to which S. & L.'s are involved in the second mortgage business?

Answer. FNMA's second mortgage investments to date consist of participations in second mortgage loans, and we expect to introduce a program for the purchase of whole loans by the end of May. Through March 31, 1982, FNMA had issued mandatory commitments to purchase $347 million of second mortgages from originating lenders. This total is composed or $171 million from savings and loan associations, $65.3 million from commercial banks, $63.1 million from consumer finance companies and $47.6 million from mortgage companies. Savings and loan associations thus constitute by far the largest source of FNMA's second mortgage activity.

The Federal Home Loan Bank Board has advised us that its preliminary report of loans held by savings and loan associations at year-end 1981 shows that these lenders held over $1 billion of second mortgages (excluding seconds on properties for which the S. & L. also holds the first mortgage). We have approved 24 savings and loans as sellers of second mortgages to FNMA and we believe that these institutions will become increasingly active in this market.

We have attempted to secure additional data concerning the sources of second mortgage lending in the United States from trade associations and knowledgeable regulators, but we were unable to obtain more complete information.

Question 5. You note that the dollar limits imposed on purchase money second mortgages in H.R. 5731 are too low in your opinion to assist in home sales in certain areas. Would you propose that separate limits be set for home improvement loans and purchase money mortgages, and if so, what different dollar limits should be set?

Answer. H.R. 5731 would restrict FNMA's authority to purchase second mortgages from savings and loan associations and other primary lenders. Currently, under its charter FNMA has the authority to purchase either first or second mortgages, or the sum of both, in an amount up to the statutory ceiling—$107,000 for a single family home.

The proposed legislation would limit FNMA's authority to purchase second mortgages to $40,000 for a single family home and $60,000 for a two-family home. It would also prohibit FNMA from purchasing second mortgages unless the individual or family used the funds acquired through the second mortgage to improve the home, or buy another one.

These provisions stem from a concern that FNMA's second mortgage activities are somehow inconsistent with the portion of its Congressional mandate to help provide adequate housing for low and moderate income families. Quite the contrary, we believe that our actions are not only consistent with our Charter, but are essential if

FNMA is to fulfill its overall Congressional mandate to provide a secondary market for housing in America, including low and moderate income housing.

Our program of purchasing second mortgages helps the housing market, is attractive to home owners and savings and loan associations, and provides FNMA with a source of funds to narrow the adverse spreads that have produced our current losses.

We also believe that this Committee should not require that money from second mortgages be used to improve or buy homes in order to make such mortgages eligible for purchase by FNMA in the secondary market. No such restriction limits savings and loan associations and other primary lenders, and FNMA should be in a position to support them.

Other strong public arguments support our position. For FNMA to try to restrict every American homeowner whose second mortgage it holds to use the funds from that mortgage only for home improvements or a home purchase would require a bureaucracy of enormous proportions. We would need auditors, accountants, investigators, and a host of additional personnel to make sure that the money was used to fix the roof, rather than send a son or daughter to medical school, pay for a sick mother in a nursing home, or help a small businessman through a recession. How would we trace the funds? Even if the Congress wanted FNMA or the primary lender to establish such a bureaucratic apparatus, is it fair to the American citizen who has put his life savings in his home, not to be able to take advantage of this investment to send a talented child through college, or after retirement just take a vacation the family had planned during their working years?

The cost of policing this restriction itself will ultimately be borne by the American homeowner. The restriction itself could have the unintended result of discouraging some Americans from investing in their own homes if their savings were to accumulate in an equity they could not use.

From the borrower's point of view, a $40,000 limit on purchase money or home improvement loans would be quite restrictive under current market conditions. Many home sale transactions are financed with second purchase money mortgages and an assumption of the first mortgage. Many homeowners desire to make substantial improvements to their homes to avoid the high costs of purchasing a new house. To the extent that the secondary market will be relied upon to provide home mortgage financing, the imposition of an artificial limit such as $40,000 will only penalize these borrowers. In sum, we see no benefit in such limitations and consider them detrimental to the interests of the secondary mortgage market, including borrowers seeking funds from this market.

Question 6. You have stated that it is Fannie Mae's intention to continue to provide the necessary support for FHA and VA mortgages. Yet the budget documents which you relayed to HUD as a backup to the budget statement on Fannie Mae published in the fiscal year 1983 budget show a marked decrease in FHA and VA purchases from $3.545 billion in fiscal year 1982 to $2.5 billion in 1983 and to $1.95 billion in 1984. At the same time, the documents show a projection of a marked increase in the purchase of conventional loans during 1983 and 1984. For what reasons are you showing such a significant decrease in FHA and VA purchases and a significant increase in conventional morgage purchases? If these figures are no longer accurate, what are your current projected plans regarding mortgage purchases for those years?

Answer. FNMA's volume of FHA/VA purchases, and market share in 1982 and thereafter reflect market forces affecting the FHA/VA market as a whole. Perhaps the most significant factor is the sharp decline of the long-term fixed rate mortgage loan in the market, as investors shun any instrument not affording protection against frequent, adverse interest rate changes. In FNMA's recent experience, there has been a marked shift to adjustable rate instruments or short-term "balloon" loans. As a long-term, fixed rate loan, the FHA/VA mortgage suffers from a severe competitive disadvantage in this market. FNMA loan purchase experience in the past six months ending March 31, 1982 suggests that the fiscal year 1982 estimate given to HUD is no longer realistic. During this period, we have purchased $670.5 million of FHA/VA mortgages. For calendar year 1982, we now estimate a total of $900 million of FHA/VA mortgage purchases. Of this total, $173 million represents FHA/VA loan purchases to date (January 1, 1982–March 31, 1982). We project FNMA FHA/VA purchases of $2 billion in 1983 and $2.6 billion in 1984.

Other factors affecting FNMA's FHA/VA purchases, in addition to investors' fear of long-term fixed rate instruments, are: market interest rate movements; operational changes, particularly the trend toward mandatory commitments; and the fact that FNMA cannot always compete with the government guaranty supporting the GNMA security. Yield spread shifts in the capital markets have made it increasing-

ly difficult for FNMA to compete against the GNMA security prices. There is a clear trend toward narrower spreads between GNMA yields and FNMA borrowing costs which is making it more difficult fo FNMA to compete for FHA/VA production.

There is another competitive reason for a shift in FNMA's FHA/VA purchases. Mortgage bankers traditionally used optional delivery commitments as a hedge or insurance policy. They would purchase FNMA commitments even if they intended to channel production to GNMA securities. This enabled them to postpone taking a mandatory delivery commitment for a GNMA security until they were close to delivery. At that point they would compare the yield required under their FNMA optional commitment with current yield requirements for GNMA securities. If interest rates had been rising, they would find the FNMA yield to be better and could deliver whole loans to FNMA rather than GNMA securities to Wall Street.

During the period from 1978 through 1981, interest rates generally were rising. Thus, more often than not, FNMA's optional yield resulted in a better price to the originator than he could obtain in the current GNMA market at delivery time. As a result, FNMA purchased many loans as yields that were below the current market.

FNMA's introduction of mandatory delivery commitments has discouraged the speculative use of optional commitments and the interest rate risk is now being more fairly distributed among FNMA, the mortgage banker and the borrower. As a result, FNMA no longer expects to encounter surges of purchases every time interest rates rise and FNMA's market share of FHA/VA production is expected to return to the levels it experienced in the relatively stable interest rate years of 1976 and 1977. Our projection of FHA/VA actvity is based on the above factors and does not in any way indicate an intention to reduce our support to the FHA/VA market.

FNMA's share of conventinal loans is expected to increase in 1982. In part, this increase is simply definitional. FNMA's purchases have historically been closely tied with new loan originations. Because of the dislocations in the mortgage market, primarily the problems experienced by thrift institutions, FNMA expects to purchase a substantial amount of older conventional loans which will be sold from thrift institutions' portfolios. These loans, which are not directly related to new loan originations, artificially increase a market share calculated by dividing FNMA purchases by total originations.

Second, thrift institutions, which have historically been the major net investor in mortgage loans, are faced with the need to alter their method of doing business. Many institutions are undertaking operations more akin to mortgage banking than their historical pattern of buy and hold. For this reason, FNMA expects that thrift institutions will originate more loans for sale to the secondary market. We are actively seeking to increase our business with thrift institutions as they change toward greater secondary mortgage market activity. Since these institutions generally originate conventional loans, FNMA's assistance in providing a secondary market outlet for their loan production would be reflected in increased conventional loan purchases by FNMA.

In conclusion, there are many market forces at work shaping the volume of FNMA's FHA/VA mortgage purchases. We do not control these forces and have no policy to discourage the sale of FHA/VA loans to FNMA. For the reasons stated, we believe that FNMA's recent FHA/VA activity is affected adversely current market conditions. FNMA will continue to provide liquidity to the FHA/VA market, with substantial purchases projected for the future in volumes to be determined by market conditions.

Response of Mr. Maxwell to Previous Question of Congressman Vento

Question. How do you answer criticism leveled with respect to manufactured houses? How do you answer critics in that arena?

Answer. Manufactured housing has been considered a more risky investment than other mortgages. To minimize this risk, FNMA has taken several precautionary steps.

Although subsection 302(b)(4) authorizes FNMA to purchase loans secured by "mortgages or other liens against manufactured housing" (chattel paper), FNMA has made loans secured by manufactured housing only when it is classified as real property.

FNMA underwrites the creditworthiness of a borrower under a manufactured housing loan exactly as it would for the purchase of a "stick-built" dwelling. We generally look for a monthly housing expense to be no more than 28 percent of the borrower's gross income, with total obligations (debts with more than 10 months to pay), including the mortgage payment, not exceeding 36 percent of the borrower's

gross monthly income. Additionally, we review for a history of steady employment, consistent income, cash reserves, and credit history.

In appraising manufacured housing, we ask that the seller/servicer provide us with our standard FNMA/FHLMC appraisal form. We review this for marketability based on comparable sales in the market area. We consider the amenities, quality of construction, and design as it relates to other comparables.

A unit manufactured as a mobile home must be built under the Federal Mobile Home Construction and Safety Standards. This standard is applicable to manufactured housing units built after June 15, 1976. Additionally, the unit must be permanently affixed to a foundation. If manufactured as a mobile home, the wheels and axles must be removed. Our Regional Offices are authorized to impose additional requirements to address different conditions in their market place. For example, the Chicago Office requires the unit to have a pitched roof. The Atlanta Office requires that each unit be permanently affixed to land by certified anchors to a 4,725 pound capacity and under-pinned on all sides of the unit with a compatible exterior material extending from the bottom of the unit to the ground. Our response to the criticism of this product is to rely on the standards we apply to the purchase of these loans, together with the improved quality of the manufactured home now available on the market.

Questions Submitted to Mr. Taylor

Question 1.—In your statement you note that market efficiencies arising from the Ginnie Mae Mortgage-Backed Securities Program reduce the cost of mortgage credit by as much as one-half of one percent to the borrower.

Could you elaborate on this?

Answer. A number of studies have concluded that the GNMA Mortgage-Backed Securities Program lowers the cost of mortgage credit to the consumer. There are at least two explanations of why this occurs. One explanation is that the so-called "market-ability premium" associated with the GNMA security has been reduced over the 12 years that this program has been in existence to the point where investors now require 50 basis points less in yield than they would if they purchased whole loans.

The second explanation is that the existence of the Mortgage-Backed Securities Program has brought a fundamental change in the marketplace over the past decade. Segmentation within the overall capital market has been reduced and this has added to the liquidity of the instrument. This, in turn, has tended to reduce the yield requirements for the GNMA by about one-half of one percent.

The efficiencies arise from the pooling of the loans and relates to servicing, payment and liquidity features. GNMA investors do not have to concern themselves with servicing individual mortgages, and payments due on the loans in a "pool" are passed through in one check instead of a number of individual monthly payments. Moreover, with the development of an active futures market in GNMA's and a broad dealer/investor network, these securities have achieved a level of liquidity far superior to that associated with individual whole mortgage loans.

Question 2.—How would you respond to the Administration's arguments that the Ginnie Mae Mortgage-Backed Securities Program should be eliminated because it "crowds out" other borrowers in the market?

Answer. It is difficult to find evidence among the available statistics that prove that GNMA has "crowded out" other investors. On the contrary, there is substantial evidence that direct Treasury borrowing have crowded out all types of credit seekers, including those that use the GNMA Mortgage-Backed Securities Program.

There is only one credit market from which all borrowers obtain funds. To the extent that anyone borrows from this credit pool, another borrower may not be able to obtain the funds it wants. Congress recognized this fact when it authorized the GNMA Mortgage-Backed Security Program in 1968. Congress understood that if homebuyers were going to obtain the credit they needed, they would have to be able to compete in the capital markets. The GNMA program offers a way for homebuyers to compete, but it does not assure them that they will receive the funds they need. Just as most other borrowers, homebuyers have to be able to pay the price that the market demands. This is true for all participants in the capital markets except one—the U.S. Treasury. The U.S. Treasury has the ability to "crowd" other borrowers out of the market because it is the only borrower that is not constrained by price. The U.S. Treasury will pay whatever the market demands for the funds it ne[illegible]. Homebuyers that use the GNMA program will simply delay their home pur- [illegible] if the cost of financing exceeds their ability or willingness to pay.

What is seldom mentioned in the "crowding out" arguments advanced against the GNMA program is that GNMA is not the borrower. GNMA securities are issued by private financial institutions and the funds raised go ultimately to the lower and moderate income consumers of housing that avail themselves of the FHA and VA programs. Because individuals served by the Federal insurance and guarantee programs are among those most affected by high interest rates, they are more likely to be "crowded out" than other borrowers.

Question 3. You criticize GNMA's proposal to revise its commitment fee structure. Apparently, HUD is counting on these higher fees to allow them to better ration commitments within an unrealistically low ceiling. You say in you statement that you doubt this will be the case because lenders will pay the necessary fee and pass those costs on to the homebuyer. Why is that the case? Don't the lenders also have the option of selling these mortgages to Fannie Mae? Why is it then that they will continue to purchase Ginnie Mae commitments?

Answer. Although lenders do have the option to sell their loans to FNMA, or any other secondary market purchaser, the greater flexibility offered by the GNMA commitment make it attractive to loan sellers. There are a number of reasons why mortgage bankers might prefer a GNMA commitment to a FNMA commitment. First, the fixed yield FNMA commitment has a term of 4 months, as opposed to the 12-month term of the GNMA commitment. Second, mechanically it is easier to deliver loans through a GNMA mortgage-backed security than it is to deliver the loans to FNMA. Third, because the FNMA price is, in part, determined by its own cost of borrowing and does not always fully reflect market forces, the price a seller can obtain for its loans through the vast GNMA market will often be higher.

However, even if the GNMA market price was the same or even lower at the time the mortgagee sought a commitment, it would probably seek GNMA commitment coverage. Market prices will vary during the period that the GNMA commitment is outstanding and this will afford the originator or packager the opportunity to pair-off its contracts and profit from certain interest rate movements.

Because of the need of mortgage bankers and others to hedge against interest rate movements, my guess is that both the GNMA and the FNMA commitments will continue to be in demand. As I stated in my testimony, the proposed higher cost associated with the GNMA program will ultimately be passed on to the homebuyer.

Questions Submitted to Mr. Waldo

Question 1. You suggest in your statement that federal credit programs such as the GNMA mortgage-backed securities program have a disruptive effect on housing credit. I would like you to clarify that for the record. Also, are you implying that if the GNMA program were eliminated the private market could immediately fill the $68 billion gap that would be left?

Answer. A GNMA certificate is backed not once, but twice by the full faith and credit of the United States Government. The underlying loans, if insured by the FHA, carry 100 percent federal insurance against losses on default, and if guaranteed by the Veterans Administration are protected against losses up to $27,500. The GNMA program requires loan originators to "pass-through" all principal and interest as received, and further to advance all installments on loans that may be delinquent. GNMA unconditionally guarantees the holders of GNMA certificates against default on these obligations of originators.

In contrast, investors in a conventional mortgage-backed security, even though of high quality investment grade, will be protected only by guarantees issued by private sector entities, such as private mortgage insurers, private sector surety companies, FNMA, FHLMC, etc. Naturally the full faith and credit guarantee of the U.S. will be preferred by investors, and so long as there is no limit imposed on the amount of GNMA certificates that can be issued it will be difficult for conventional mortgage-backed securities to achieve their full potential. This is particularly ironic in view of the fact that FHLMC's PCs trade at 10 to 30 basis points and the new FNMA conventional security at 50 to 60 basis points over a typical GNMA yield; and other conventional mortgage-backed securities issued in the illiquid private placement market command only a 1 percent yield differential. By contrast, the difference in yield between a T-Bond and an AAA corporate bond of equal maturity or between a GNMA certificate and a ten year T-Bond will range from 1.0 percent to 1.2 percent.

From the foregoing, it is clear that the government's guarantee in the case of GNMA certificates does not command the same investor preference as it does in the case of other government debt securities. Yet GNMA certificates, with the full faith and credit of the United States Government behind them, are Federal Government

securities. Many investors who buy GNMA's are not doing so to invest in mortgages; they are doing so to get an extremely high yield on the safest investment in the world—debt secured by the full faith and credit of the United States Government. In 1981, GNMA issued $14.257 billion in new certificates. The U.S. Treasury issued $7.745 billion in ten-year bonds. It is easy to deduce that sooner or later the ten-year T-Bond yield will catch up with the GNMA yield; and since the cost of funds to the United States sets the bench mark for all other debt, it is clear that *all* borrowers will pay the price for the profligate use of Federal credit guarantees.

In my full statement I pointed out that 70 percent to 80 percent of the funds to finance housing formerly was provided by portfolio lenders, which in the future must come from the general capital markets. Estimates of housing's aggregate capital needs for the next 10 years range up to $4 trillion. If the only access to the general capital markets is GNMA certificates we will have issued "government securities" in amounts of 3 to 4 times the current national debt; yet these "government securities" will not have raised one dime to finance the direct needs of the government. From this perspective it is compellingly clear that the only feasible way of financing housing in the future is through the private sector. Private alternatives to GNMA must be given room to grow and prosper, and the best way to make that room is to give the market place a clear signal that GNMA, in stages, will be redirected to its original purpose of aiding those who cannot be economically served by the private sector.

We believe that given the structure for an easily marketed conventional mortgage-backed security, the private market would "fill the gap" left by the withdrawal of GNMA. The gap in fiscal year 1982 would not be $68 billion—that is GNMA's commitment authorization, but the amount of certificates actually issued will be more in the neighborhood of $20 billion. The annual need for mortgage-backed securities in the future, however, will exceed the amount issued by GNMA in any previous year; and as we have said before, we believe the private sector can and will fill that need, given the appropriate legal structure that will allow conventional mortgage-backed securities to be easily and conventionally brought to market.

Question 2.—You have indicated that you believe FHA and GNMA crowd out non-government sources of funds. You seem to imply that redirecting FHA to first-time home buyers and inner city residents will somehow reduce this so-called crowding out. Could you explain that further?

Answer. The original purpose of the FHA was to insure high-ratio loans that would not have been made under lending practices then considered reasonable and prudent. The private mortgage insurance industry picked up and developed on this theme from the late '50's and early '60's. In the late '60's and early '70's the FHA shifted its emphasis to even higher risks involved in various subsidy programs, and GNMA was created in 1968 to provide a capital outlet for these sub-marginal risk loans.

In the then existing market, when portfolio lenders furnished 75–80 percent of the funds for housing, the presence of the government programs had no "crowding-out" effect. In a typical year the FHA would insure about 11 percent of all loans orginated, and GNMA certificates would represent about 15 percent of all funds devoted to mortgages. "Crowding-out" becomes a problem, however, when a dislocation occurs such as is occurring now—when lenders who were previously portfolio lenders are forced to turn to the capital markets and they have no vehicle to do so conveniently other than the use of the GNMA program. Then "crowding-out" will occur, because of the inherent differences between the guarantees provided in a conventional mortgage-backed security and those provided by GNMA's.

Redirecting the FHA to its original purpose—helping those who cannot economically be served by the private sector—will reduce the "crowding-out" simply because fewer FHA insured loans will be available for inclusion in GNMA pools. We estimate that fully 80 percent of the FHA's current business would qualify for conventional financing with private mortgage insurance. At the same time, however, the FHA would be available to assist those who do need their help. We believe it is essential that the FHA and GNMA programs remain available to help in these situations.

As to where, specifically, the FHA should be "redirected", I would like to emphasize a point made in our previously submitted statement.

We noted that the Administration's Budget recommends limiting FHA's operations to first-time home buyers and inner cities. While the redirection is commendable and we support the Administration's recommendation, we do not concede that our industry is unable to serve first-time home buyers and inner cities. We are e in both market areas. Thirty-six percent of our insurance in 1981 involved 5 down payments and these were principally first-time home buyers. Thirty-

six percent of our insurance in 1981 represented 127,248 first-time home buyers; yet in all of the FHA home mortgage insurance programs, the agency in 1981 insured 175,052 mortgages. If two-thirds of these were first-time home buyers, our industry assisted more first-time home buyers in 1981 than the FHA.

The low down payment first-time home buyer does not represent a neglected market. According to the Primary Mortgage Market Survey of FHLMC dated March 19, 1982, the percentage of lenders offering 95 percent loans during the week ending March 19 increased sharply to 63.4 percent from 52.5 percent the previous month.

We are pleased that our industry continues to play a predominant role in assisting first-time home buyers. It is not lack of a willing lender or of a willing insurer that prevents more first-time buyers from entering the market, however. It is apparent that the real villains are high interest rates and the resultant affordabiiity problems which continue to bar many first-time home buyers from the market, regardless of the source of their mortgage insurance. These problems must be addressed by legislation which is now pending before this Subcommittee which would help bridge the affordability gap through interest rate subsidies.

Question 3.—You mention in your testimony that there are numerous legislative and regulatory restrictions which impede the access of conventional loans to the capital markets. Could you be more specific as to what are these impediments and what proposals you have for removing them?

Answer. The impediments are basically three in nature.

1. Securities registration and state "Blue Sky" requirements for conventional mortgage-backed securities have not been crystalized, for the simple reason that until now there has been no need to do so. FNMA's and FHLMC's securities will enjoy some freedom from these regulatory restrictions, but we believe the conventional mortgage-backed securities market should encompass more than the programs of these agencies. In 1981, Senator D'Amato considered proposing a bill, copy attached, which would have eliminated these concerns. Simplification of registration is needed (a) so that conventional mortgage-backed securities can be marketed with the same facility as GNMA certificates; and (b) to allow "conduits" or assemblers of loans for pooling to do so without inordinate risks of having shifts in interest rates impair the marketability of their inventory of loans.

2. The institutions which are potential investors in these securities are subject to various regulations which make it unclear as to whether investment in a conventional mortgate-backed security would be legal. For example, many state laws prohibit life insurance companies from investing in high ratio loans unless government insured or guaranteed. Until they can be assured that a conventional mortgate-backed security won't be construed as a high ratio loan in disguise many life insurers will simply not consider them as investments. Despite recent positive strides, such as amendment of ERISA regulations, questions still persist under various state laws and other regulations which inhibit many such potential investors from buying conventional loans or conventional mortgage-backed securities. Sweeping legislation is needed to circumvent or supersede restrictive laws and regulations that retard such institution's investments in housing. Unfortunately we have no specific proposal to furnish at this time.

3. Given a solution to the previous matters, a large institution could originate conventional loans and thereafter create and market conventional mortgage-backed securities. However, even large institutions have difficulty assembling pools of loans from diverse geographic areas, which may be preferable to investors. Loans assembled by such "conduit" companies may be subject to double taxation, and until these uncertainties are resolved a free market for conventional mortgage-backed securities will be inhibited. This particular aspect will especially affect the small, localized lenders, who are responsible for a substantial majority of all mortgage originations. They, particularly, will have difficulty accessing the capital markets through conventional mortgage-backed securities. Again, we have no specific proposal to offer at this time, other than to point out that substantial research into the tax laws and regulations is required.

S. ___ .

IN THE SENATE OF THE UNITED STATES

A BILL

To exempt from the Securities Act of 1933 certain securities secured by pools of first liens on single family homes

Be it enacted by the Senate and House of Representatives of the United States of American in Congress assembled, that section 3(a) of the Securities Act of 1933 is amended by adding a new subsections (12) as follows:

(12)(A) Any securities issued by a savings and loan association, savings bank, commercial bank, or other lending institution as described below, which securities are secured by a pool of first liens on single parcels of real estate upon which are located single family dwellings:

(i) where such securities are issued by a savings and loan association, savings bank, commercial bank, or similar banking institution which is supervised and examined by a Federal or State authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 1709 and 1715b of Title 12 U.S. Code, and such first liens which secure such security are:

(a) originated by a savings and loan association, savings bank, commercial bank, or similar institution

:

which is supervised or examined by a Federal or State authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections [illegible] and [illegible] of Title 12 U.S. Code; and

(b) insured by a mortgage insurer deemed qualified by the Federal National Mortgage Association pursuant to section 302 of the National Housing Act or the Federal Home Loan Mortgage Corporation Act (12 USC 1451) if the ratio of loan to value of each such first lien is in excess of eighty percentum, and

(ii) the securities are offered and sold subject to the following conditions:

(a) the minimum issue shall not be less than $1,000,000;

(b) the minimum aggregate sales price per purchaser shall be not less than $25,000;

(c) the purchaser shall pay cash either at the time of sale of within sixty days thereof; and

(d) each purchaser shall buy for his own account only.

(B) The exemption provided by subparagraph A shall not apply to resales of the securities acquired pursuant thereto, unless each of the conditions in subparagraph (A)(i) and (ii) are satisfied.

Mr. VENTO. I have to run for a vote. We thank you all for your testimony and attendance. We look forward to interesting dialog.

The meeting is recessed until 2 o'clock this afternoon.

[Whereupon at 12:20 p.m. the hearing was recessed to reconvene at 2 p.m.]

AFTERNOON SESSION

Mr. ST GERMAIN [presiding]. The subcommittee will come to order. Our first witness this afternoon is the Honorable Cecil Heftel from the, believe it or not, State of Hawaii. We welcome you this afternoon and we express our appreciation for taking the time to come and share your views.

STATEMENT OF HON. CECIL "CEC" HEFTEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF HAWAII

Mr. HEFTEL. I would ask unanimous consent to introduce my prepared statement in the record and then to merely summarize.

Mr. ST GERMAIN. Without objection, so ordered.

Mr. HEFTEL. I realize that the expertise is on the other side of the microphone and I am here really to applaud your leadership in introducing H.R. 5568, in an atmosphere where nothing is occurring anywhere within the system, and we are watching the rapid demise of our thrift institutions along with our homebuilding industry. I would hope that we would also take note of the fact that the underlying problem is high interest rates.

More than just the thrifts and the housing industry are adversely affected by these interest rates. I would hope that somehow, along with your legislation, the Congress and the administration could put together a program with the Chairman of the Federal Reserve that addresses that problem, because there is no way that the economy can successfully go forward carrying the present high interest rates and their attendant uncertainty.

And I would be delighted to answer any questions you may have, Mr. Chairman.

[Mr. Heftel's prepared statement follows:]

STATEMENT OF

CONGRESSMAN CECIL "CEC" HEFTEL

BEFORE THE SUBCOMMITTEE ON

HOUSING AND COMMUNITY DEVELOPMENT

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITTEE, I APPRECIATE THIS OPPORTUNITY TO EXPRESS MY STRONG SUPPORT FOR H.R. 5568, THE HOME MORTGAGE CAPITAL STABILITY ACT. I WANT TO ADD MY VOICE TO THE GROWING CHORUS OF CONCERN -- AND ALARM -- OVER THE CRISIS FACING OUR THRIFT AND HOUSING INDUSTRIES. IT IS INCREASINGLY APPARENT THAT PROMPT REMEDIAL ACTION MUST BE TAKEN BY CONGRESS IF WE ARE TO AVERT A FULL-SCALE COLLAPSE OF THE MORTGAGE AND HOMEBUILDING SECTORS OF OUR ECONOMY. I COMMEND THIS COMMITTEE FOR THE LEADERSHIP IT HAS PROVIDED IN ADDRESSING THIS MOST SERIOUS AND PRESSING PROBLEM.

I BELIEVE THAT H.R. 5568, INTRODUCED BY CHAIRMAN ST GERMAIN, IS A PROMISING START TOWARD A COMPREHENSIVE SOLUTION TO THE THRIFT AND HOUSING PROBLEMS. CAPITAL INFUSIONS FROM THE BILL'S HOME MORTGAGE CAPITAL STABILITY FUND WOULD PROVIDE THE SAVINGS AND LOAN INDUSTRY WITH MUCH-NEEDED BREATHING ROOM DURING THE CURRENT DIFFICULT PERIOD. THIS SHORT-TERM RELIEF OF THE THRIFTS WOULD, IN TURN, HAVE IMMEDIATE AND POSITIVE EFFECTS ON THE HOUSING INDUSTRY, BY MAKING AVAILABLE

ADDITIONAL MORTGAGE AND FINANCING FUNDS. THE APPROACH OF H.R. 5568 IS SOUND AND COST-EFFECTIVE, AND IT CORRECTLY RECOGNIZES THAT THE PROBLEMS OF THRIFT AND HOUSING INDUSTRIES ARE INTERRELATED.

NO AMOUNT OF SHORT-TERM RELIEF WILL BE SUCCESSFUL, HOWEVER, WITHOUT A COHERENT, LONG-RANGE STRATEGY TO ATTACK THE INTEREST RATE CRISIS. AS LONG AS THESE RATES REMAIN AT THEIR CURRENT ASTRONOMICAL LEVELS, HOUSING WILL REMAIN UNAFFORDABLE AND MORTGAGE INSTITUTIONS WILL REMAIN UNPROFITABLE. HIGH INTEREST RATES ARE THE INDISPUTABLE CRUX OF THE PROBLEM. WITHOUT A READILY ACCESSIBLE POOL OF CAPITAL AT REASONABLE RATES, THE AMERICAN DREAM OF HOME OWNERSHIP WILL SIMPLY BE NO MORE. ACCORDINGLY, ANY SHORT-TERM AID TO THE HOUSING AND THRIFT INDUSTRIES IS, AT BEST, ONLY A PALLIATIVE UNTIL INTEREST RATES COME DOWN.

THIS IS NOT TO SAY THAT INTERIM RELIEF IS NOT URGENTLY NEEDED -- IT IS. HOUSING STARTS ARE NEAR POST-WAR LOWS. UNEMPLOYMENT IN THE CONSTRUCTION INDUSTRY IS OVER 18 PERCENT. IN MY OWN STATE OF HAWAII, THE REAL ESTATE MARKET IS AT A VIRTUAL STANDSTILL AND CONSTRUCTION ACTIVITY IS DECLINING DRAMATICALLY. THE HOUSING SECTOR OF OUR ECONOMY SHOULD NOT BE HELD HOSTAGE BY ECONOMIC CONDITIONS OUT OF ITS CONTROL. EMERGENCY MEASURES ALONG THE LINES OF H.R. 5568 ARE NEEDED IMMEDIATELY IF WE ARE TO STAVE OFF THE VIRTUAL DISSOLUTION

TO REFORM OUR NATION'S FINANCIAL STRUCTURE, I STRONGLY BELIEVE THAT SUCH REFORM SHOULD BE UNDERTAKEN ON A COMPREHENSIVE BASIS. FINANCIAL RESTRUCTURING ON THE BASIS OF ECONOMIC DARWINISM -- AS IS CURRENTLY BEING DONE -- IS A DESTRUCTIVE POLICY. I URGE THE COMMITTEE TO SERIOUSLY CONSIDER THIS LARGER ISSUE AS IT STRIVES TO PROVIDE SHORT-TERM RELIEF TO THE HOUSING SECTOR.

MR. CHAIRMAN, THANK YOU AGAIN FOR LETTING ME SHARE MY THOUGHTS ON THIS CRITICAL ISSUE WITH YOU AND THE DISTINGUISHED MEMBERS OF THIS COMMITTEE. I LOOK FORWARD TO WORKING WITH YOU IN DEVELOPING A WORKABLE PROGRAM TO REVIVE THE HOUSING AND MORTGAGE INDUSTRIES. I BELIEVE H.R. 5568 IS A PROMISING START TO THIS END.

Mr. St Germain. Well, the Chair would be hard put to ask any questions, because of the Chair's gratitude and admiration for the Member of Hawaii, and my gratitude for your cooperation and assistance.

Our endeavor to try to do something immediately to prevent a continued erosion of the thrift industry is an essential part of the financial delivery system of this country. I would merely extend my gratitude.

Mr. Lundine?

Mr. Lundine. I have no questions.

Mr. St Germain. There being no further questions, I say again thank you.

Next we have a panel of Mr. John Malarkey, State bank commissioner, State of Delaware, vice chairman of Federal Legislation Committee, the Conference of State Bank Supervisors; Mr. Raymond Tiernan, National Association of State Savings & Loan Supervisors; Muriel Siebert, superintendent of banks, New York State Banking Department and Mr. Michael Horn, commissioner of banking, State of New Jersey.

Our first witness, as listed on the notice, is Mr. Malarkey. We will put your entire statement in the record and you may proceed.

STATEMENT OF JOHN E. MALARKEY, STATE BANK COMMISSIONER, STATE OF DELAWARE, AND VICE CHAIRMAN OF FEDERAL LEGISLATION COMMITTEE, CONFERENCE OF STATE BANK SUPERVISORS

Mr. Malarkey. Thank you, Mr. Chairman.

Mr. Chairman, members of the subcommittee, I am John Malarkey, State bank commissioner of the State of Delaware and vice chairman of the Federal legislation committee of the Conference of State Bank Supervisors on whose behalf I am testifying today.

The Conference of State Bank Supervisors is the professional or- ıization of State officials who charter, regulate, and supervise ıproximately 10,500 State-chartered commercial and mutual ngs banks of the Nation.

On one hand, CSBS is pleased to have this opportunity to testify. On the other hand, we would rather that the state of our Nation's affairs had never come to the point where hearings such as this have become necessary.

Emergency legislation such as the type Chairman St Germain has proposed is never desirable. It can only be necessary. Legislation such as this makes winners of no one. It only increases the survivors list.

We salute Chairman St Germain for the sense of responsibility and devotion to duty shown in sponsoring H.R. 5568.

CSBS rises in support of H.R. 5568; not because we want to, but because we have to. Our support of H.R. 5568 is premised on the understanding that it will be amended as the chairman has indicated to limit Government infusions in keeping with the net worth guarantee concept.

Reflecting inflationary monetary and fiscal policies during much of the 1965–79 period and consequent extremes in interest rates, thrift institutions of this Nation are facing red ink and potential failures of unprecedented proportions.

While mismanagement may have contributed in individual cases and usury or due-on-sale prohibitory laws have contributed in some States, the overriding cause of the industry's plight has been Federal Government action.

Philosophically, the Conference is opposed to direct Government assistance to failing institutions. Failure is as much a part of our economic system as is success.

Yet, the threat which is currently posed goes beyond the institutions we regulate to the very system under which we regulate. We are actors in a scene which, if played to final curtain, may well mean the demise of the dual banking system.

Increased concentration of the financial institution industry and increased centralization of governmental control over the industry and the economy, the directions in which the current chain of events is leading us, are to be more feared and abhorred than a one-time Government infusion.

Mr. Chairman, hard times make for hard solutions.

The problems of the depository institutions, particularly the thrifts, are too well chronicled for me to bother this subcommittee with the gory details.

The Banking Committee has taken countless pages of testimony on the imbalance between the low yielding portfolios, filled with long-term mortgages, and the current high cost of money.

I myself appeared before the Subcommittee on Domestic Monetary Policy last year to discuss the massive outflows of funds suffered by traditional depository institutions at the hands of the money market mutual funds. The whipsaw of the money cost/portfolio yield mismatch and competitors not subject to interest rate control has brought the thrift industry to its darkest hour.

The safety and soundness of State-chartered mutual savings banks is in question, as well as S. & L.'s nationwide. In addition, threats to the safety and soundness of the thrift industry could well have a spillover effect on the commercial banking industry, since the public often fails to distinguish between types of deposi-

tory institutions. The potential liability of the FDIC and FSLIC, backed by the full faith and credit of the Nation, is enormous.

Unless the current money cost/portfolio yield mismatch is addressed, the short-term picture is dismal and other steps with longer timeframes are irrelevant.

Immediate assistance is required, of the type embodied in Chairman St Germain's proposals.

H.R. 5568, the Home Mortgage Capital Stability Act, is a good bill under the circumstances. Chairman St Germain's decision to use net worth guarantees rather than actual capital infusions makes it even better. None of the other approaches with which we are acquainted come close.

Let me discuss H.R. 5568 in terms of the considerations deemed important by CSBS. In order to garner CSBS support, a Federal assistance program must be cost-effective, avoid a mass, across-the-board subsidy and require the repayment of aid.

H.R. 5568, with the net worth guidance concept replacing the use of capital participation notes, satisfies those concerns.

The best way to insure cost-effectiveness is to target a program narrowly to those which truly need assistance and have a high probability of being saved if they get it.

While the institutional qualifications set forth in H.R. 5568 are acceptable, we believe they could be tightened by changing the net worth trigger from less than 2 percent of assets to less than 1.5 percent of assets; by requiring that at least 30 percent of its current portfolio be in one-to-four family residences or in condominium or cooperative units; and by requiring that the primary regulator determine the institution's long-term viability, determine that the institution would have to be closed within the next 12 months without such aid, but would live with it, determine that the institution's losses have been caused by governmental action rather than mismanagement and that management of the institution is committed to its survival.

As is obvious, the suggested changes are minimal except for the last concept, that is determination by the primary regulator of viability, need, cause of problem and commitment of management.

CSBS believes that the program should maintain the viability of well managed but troubled institutions as determined by the primary regulator, the chartering department or agency, whether State or Federal.

The primary regulator, under whose constant watchful eye the institution operates, is the best judge of matters such as the quality of management, the prospect for long-term viability and the need for and probable impact of assistance under a Federal program.

Not only does CSBS believe this to be a better control over eligibility, but we believe it to be more consistent with the role and function of the agencies involved under our current system of financial institution regulation.

CSBS believes that the final form of the assistance program must be nonpreemptive of State authority and give the Federal agencies a minimum of additional oversight responsibility and no equity interest in the assisted institutions.

There is no reason that any destruction of the parallel State-Federal authorities within the dual banking system must flow from

legislation such as this. The authority of the primary regulator should be kept intact and no equity interest should be taken by the Government.

In determining an institution's need for aid under an assistance program, CSBS believes that the condition of the parent holding company should be factored into the decision, where the institution to be assisted is owned by a holding company.

Not only will this insure that public funds are not used where private funds are available, it will insure against double dipping in cases of supervisory mergers or acquisitions.

The requirements for participation should be modified to eliminate the cap on the interest rate on loans made under this section. Since the viability of institutions is desirable under this program, limits should not be imposed which hurt the institution's chances to turn its portfolio around, rebuild reserves and repay any moneys received from the Government.

Rather, a higher percentage reinvestment of new deposits in mortgages should be considered, such as 60 percent rather than 50 percent.

In regard to the types of aid available under the bill, it is clear that CSBS prefers the "net worth guarantee" proposal to the capital participation note approach taken by the original bill.

The "net worth guarantee" approach not only decreases the upfront cost of the program, it removes incentive for institutions to contrive ways to move into the assistance eligibility category.

Under the "net worth guarantee" approach, there would be little or no cost to the Federal budget if economic recovery, accompanied by lower interest rates, evolves as predicted by the administration.

H.R. 5568 becomes effective, in essence, only if the current worsening trend continues well beyond 1982. No need, no cost. It is that simple. Yet, if the need arises, the mechanism is in place to assist troubled institutions.

In point of fact, it might be feasible to use a combination of the "net worth guarantee" concept with expanded statutory authority for Federal insuring agencies to make loans to, make deposits in, purchase the assets or securities of, or assume the liabilities of any insured commercial bank, savings bank or savings and loan association.

The primary goal would be to facilitate the continued operation of well managed but troubled institutions. Such a tiding over of troubled institutions could also help to avert other, more serious, negative consequences of the state of our economy.

Mr. Chairman, CSBS supports legislation to assist, on a one-time basis, well managed but seriously troubled institutions whose troubles largely reflect interest rate extremes, as brought about primarily by extremes in past Federal monetary and fiscal policies.

But, we also would echo the thought expressed by Chairman St Germain that one must oppose thrift aid measures that do not narrowly target funds to those institutions that need them the most and could be made viable in the long term by the assistance.

The aid program should be modeled in such a way so as to maintain the authority of the primary regulator and the integrity of our decentralized system of State determination of structure.

CSBS supports H.R. 5568, amended to incorporate the "net worth guarantee" concept. We hope that our few suggestions today will be incorporated into the legislation by the Banking Committee.

However, CSBS hopes that Congress and the Banking Committee will not stop with H.R. 5568. This bill takes care only of the symptoms, symptoms of both our current economic malaise and new forces in the financial institution industry. In order to truly help, Congress must: One, vigorously support responsible monetary and fiscal policies; and, two, provide traditional depository institutions with a rate-competitive instrument.

Everyone speaks to you about the first of these. Let me address the second for just a moment.

Nationwide, the phenomenal growth of money market mutual funds has represented the most massive translocation of funds, going from about 45 States to a handful of money market centers, this Nation has ever experienced.

They are bleeding numerous State and local communities of their economic life blood to the tune of $188 billion in assets. Infusions of assistance in the amounts which you are discussing pale by comparison.

Every day new unregulated competitors seek to enter the banking business through one legal loophole or another. To some extent these loopholes can be closed.

However, the only way to insure the long-run viability of the depository institutions industry is to give it the pricing tools to compete.

Unless Congress or the DIDC acts to give depository institutions a rate-competitive instrument, the condition of the depository industry will only continue to worsen. Depository institutions across the Nation are constantly seeking avenues to circumvent rate restrictions within the law.

The majority have realized that they can better afford an increased cost of funds than a massive loss of deposits.

Let this exercise be not only one in which Congress underwrites the survival of those troubled institutions who deserve to survive, but one in which Congress gives healthy institutions the rate competitive tools they need to remain healthy as well.

If not, H.R. 5568 may be nothing than the first in a long series of assistance bills.

Thank you, Mr. Chairman.

[Mr. Malarkey's prepared statement, on behalf of the Conference of State Bank Supervisors, follows:]

STATEMENT OF MR. JOHN E. MALARKEY

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

RE: H.R. 5568 - THE HOME MORTGAGE CAPITAL STABILITY ACT

MARCH 31, 1982

Mr. Chairman, members of the Subcommittee, I am John E. Malarkey, State Bank Commissioner for the State of Delaware and Vice Chairman of the Federal Legislation Committee of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, regulate and supervise the approximately 10,500 state-chartered commercial and mutual savings banks of the nation. Created in the early 20th Century as a clearing house for the ideas of the state bank supervisors on common problems, CSBS has evolved into the major champion of our decentralized American banking and bank regulatory structures. In addition, the Conference has become the most significant single source of educational and research services aimed at strengthening individual state banking departments.

On one hand, CSBS is pleased to have this opportunity to testify. On the other hand, we would rather that the state of our nation's affairs had never come to the point where hearings such as this have become necessary.

Emergency legislation such as the type Chairman St Germain has proposed is never desirable. It can only be necessary. Legislation such as this makes winners of no one. It only increases the survivors list.

We salute Chairman St Germain for the sense of responsibility and devotion to duty shown in sponsoring H.R. 5568.

CSBS rises in support of H.R. 5568; not because we want to, but because we have to. Our support of H.R. 5568 is premised on the understanding that it will be amended as the Chairman has indicated to limit government infusions in keeping with the "net worth guarantee" concept.

Reflecting inflationary monetary and fiscal policies during much of the 1965 to 1979 period and consequent extremes in interest rates, thrift institutions of this nation are facing red ink and potential failures of unprecedented proportions. While mismanagement may have contributed in individual cases and usury or due-on-sale prohibitory laws have contributed in some states, the overriding cause of the industry's plight has been federal government action.

Philosophically, the Conference is opposed to direct government assistance to failing institutions. Failure is as much a part of our economic system as is success.

Yet, the threat which is currently posed goes beyond the institutions we regulate to the very system under which we regulate. We are actors in a scene which, if played to final curtain, may well mean the demise of the dual banking system.

Increased concentration of the financial institution industry and increased centralization of governmental control over the industry and the economy, the directions in which the current chain of events is leading us, are to be more feared and abhorred than a one-time government infusion.

Mr. Chairman, hard times make for hard solutions.

The problems of the depository institutions, particularly the thrifts, are too well chronicled for me to bother this Subcommittee with the gory details. The Banking Committee has taken countless pages of testimony on the imbalance between the low yielding portfolios, filled with long-term mortgages, and the current high cost of money. I myself appeared before the Subcommittee on Domestic Monetary Policy last year to discuss the massive outflows of funds suffered by traditional depository institutions at the hands of

the money market mutual funds. The whipsaw of the money cost/portfolio yield mismatch and competitors not subject to interest rate control has brought the thrift industry to its darkest hour.

The safety and soundness of state-chartered mutual savings banks is in question, as well as S&Ls nationwide. In addition, threats to the safety and soundness of the thrift industry could well have a spill-over effect on the commercial banking industry, since the public often fails to distinguish between types of depository institutions. The potential liability of the FDIC and FSLIC, backed by the full faith and credit of the nation, is enormous.

CSBS has called for the creation of a rate-competitive deposit-type instrument for all traditional depository institutions, in order to stem the outflow of funds to the new and novel non-depository financial competitors.

CSBS has called for a prohibition on third party powers for money market mutual funds.

CSBS supported emergency legislation introduced by Chairman St Germain to permit supervisory cross-industry and interstate acquisitions after adoption of CSBS-sponsored amendments to moderate the preemption contained in such legislation and to McFaddenize S&Ls acquired by BHCs.

CSBS has testified against extending to the thrift industry commercial bank asset powers without equalizing competition and subjecting S&Ls to state authority under the rubric "no homogenization without McFaddenization," but has generally taken a "no policy" stance on increased asset powers for thrifts.

Yet, none of the above measures addresses the problem created by the now historically high interest rates. Unless the current

money cost/portfolio yield mismatch is addressed, the short-term picture is dismal and other steps with longer time frames are irrelevant.

Immediate assistance is required, of the type embodied in Chairman St Germain's proposals.

H.R. 5568, the "Home Mortgage Capital Stability Act," is a good bill under the circumstances. Chairman St Germain's decision to use "net worth guarantees" rather than actual capital infusions makes it even better. None of the other approaches with which we are acquainted come close.

Let me discuss H.R. 5568 in terms of the considerations deemed important by CSBS. In order to garner CSBS support, a federal assistance program must be cost effective, avoid a mass across the board subsidy and require the repayment of aid. H.R. 5568, with the "Net Worth Guarantee" concept replacing the use of capital participation notes, satisfies these concerns.

The best way to ensure cost-effectiveness is to target a program narrowly to those which truly need assistance and have a high probability of being saved if they get it. While the institutional qualifications set forth in H.R. 5568 are acceptable, we believe they could be tightened by changing the net worth trigger from "less than 2% of assets" to "less than 1.5% of assets;" by requiring that at least 30% of its current portfolio be in one-to-four family residences or in condominium or cooperative units; and by requiring that the primary regulator determine the institution's long-term viability, determine that the institution would have to be closed within the next twelve months without such aid, but would live with it, determine that the institution's losses have been caused by

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Under the "Net Worth Guarantee" approach there would be little or no cost to the federal budget if economic recovery, accompanied by lower interest rates, evolves as predicted by the Administration. H.R. 5568 becomes effective, in essence, only if the current worsening trend continues well beyond 1982. No need -- no cost. It is that simple. Yet, if the need arises, the mechanism is in place to assist troubled institutions.

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any insured commercial bank, savings bank or savings and loan association. The primary goal would be to facilitate the continued operation of well-managed but troubled institutions. Such a tiding over of troubled institutions could also help to avert other, more serious, negative consequences of the state of our economy.

SUMMARY AND CONCLUSIONS

Mr. Chairman, CSBS supports legislation to assist, on a one-time basis, well-managed but seriously troubled institutions whose troubles largely reflect interest rate extremes, as brought about primarily by extremes in past federal monetary and fiscal policies.

But, we would echo the thought expressed by Chairman St Germain that one must oppose thrift aid measures that do not narrowly target funds to those institutions that need them the most and could be made viable in the long-term by the assistance.

The aid program should be modeled in such a way so as to maintain the authority of the primary regulator and the integrity of our decentralized system of state determination of structure.

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However, CSBS hopes that Congress and the Banking Committee will not stop with H.R. 5568. This bill takes care only of the symptoms, symptoms of both our current economic malaise and new forces in the financial institution industry. In order to truly help, Congress must:

1. Vigorously support responsible monetary and fiscal policies; and

2. Provide traditional depository institutions with a rate-competitive instrument.

Everyone speaks to you about the first of these. Let me address the second for a moment.

Nationwide, the phenomenal growth of money market mutual funds has represented the most massive translocation of funds, going from about 45 states to a handful of money market centers, this nation has ever experienced. They are bleeding numerous state and local communities of their economic life-blood, to the tune of [illegible] billion dollars in assets. Infusions of assistance in the amounts which you are discussing pale by comparison.

Every day new unregulated competitors seek to enter the banking business through one legal loophole or another. To some extent these loopholes can be closed.

However, the only way to ensure the long-run viability of the depository institutions industry is to give it the ability to compete. Unless Congress or the DIDC acts to give depository institutions a rate-competitive instrument, the condition of the depository industry as a whole will only continue to worsen. Depository institutions across the nation are constantly seeking avenues to circumvent rate restrictions within the law. The majority have realized that they can better afford an increased cost of funds than a massive loss of deposits.

Let this hearing be not only one in which Congress [illegible] the survival of those [illegible] institutions [illegible], but one in which Congress [illegible] competitive [illegible]. [illegible]

Thank you, Mr. Chairman.

Chairman GONZALEZ. Thank you very much, Mr. Malarkey. We appreciate your statement, and the fact that we had it in time to review it.

We next recognize Ms. Siebert, but I was going to yield to my distinguished colleague from New York, Mr. LaFalce and if he wishes to yield his power to the gentleman from New York?

Mr. LAFALCE. Would you like me to yield to Mr. Schumer?

Chairman. GONZALEZ. I said you exercise your judgment as to whether you wish to defer to a junior New Yorker.

Mr. LAFALCE. Ladies and gentlemen, in those famous immortal words, here is Mickey, a good friend and a great superintendent. I now yield to Chuck.

Mr. SCHUMER. I welcome the superintendent of banks from New York and thank the chairman of our subcommittee for allowing her to testify. I would just say that if I could think of probably the least thankless job in the United States of America, at this point in time, it would be superintendent of banks in New York.

She has done a great job in very trying circumstances. Welcome.

STATEMENT OF MURIEL SIEBERT, SUPERINTENDENT OF BANKS, NEW YORK STATE BANKING DEPARTMENT

Ms. SIEBERT. Thank you. I happen to agree with you. No one likes a bank regulator today.

Mr. SCHUMER. I yield back to my senior and distinguished colleague. Which senior and distinguished colleague?

Mr. LAFALCE. I yield back to my more senior and more distinguished colleague.

Mr. GONZALEZ. Ms. Siebert?

Ms. SIEBERT. My name is Muriel Siebert. I am New York State Superintendent of Banks. I appreciate the opportunity to comment on the legislation this subcommittee is considering with respect to thrift institutions.

First, let me say that I support H.R. 5568, as it has been amended by Representative St Germain, with certain additional changes I will refer to in my testimony.

I do not believe this subcommittee needs another reiteration of the problems of the thrift industry. New York State-chartered mutual savings banks, which represent 96 percent of the assets of thrifts for which I am responsible, experienced an aggregate net operating loss during 1981 of $1.25 billion.

All thrifts in New York lost $1.7 billion in 1981—97 of our 99 banks were on the minus side of the ledger. In addition, New York State-chartered mutual savings banks, aggregate net worth declined by 20 percent over the course of the year.

There was a time when many people thought that the "thrift problem" was a "New York problem." This may only have been because the attractiveness of alternative vehicles of investment, earning higher rates of interest, was more quickly perceived in the Nation's leading financial center.

In any case, whatever its past history, it is now clear that the "thrift problem" today is a national problem. The Brookings Insti-
for example, predicts failures or mergers for over 1,000 sav-

ings and loan associations nationwide, by the end of 1983, unless interest rates go down, and remain at a reasonably low level.

Wharton's recent study projects that even with a drop in interest rates, a comprehensive Federal program is necessary to get these institutions through this difficult period.

I am pleased that the mergers, which were arranged by the FDIC, working with the New York State Banking Department, involved thrifts with thrifts, and within New York State. They have helped preserve and strengthen the thrift industry in our State and will allow it to continue its traditional commitment to home financing.

While I am a proponent of interstate banking, these mergers did not create de facto interstate banking. It gives Congress more time to address this issue.

The situation is, however, delicate in the extreme. We have recently seen how a newspaper mention could trigger a real run, on the Hartford Savings & Loan Association. In a recent article, Mr. Carriola, chairman of the bank, referred to the advice an out-of-State supervisor gave him.

I am proud to have been the supervisor he referred to and able to contribute to this problem. I say this not to brag, but to demonstrate that we have been preparing for such an emergency. I shudder to think what might have happened and a similar stimulus touched off a comparable reaction among the nearly half-million depositors of the New York Bank for Savings.

Furthermore, although New York State has dealt with its immediate problems, there will be, before too long, unless a comprehensive Federal program is enacted, a second round of New York State-chartered savings banks to cope with. This list, I must tell you, involves a greater number of multibillion dollar institutions.

We in New York State are acutely aware of the problem. Governor Carey has appointed a special task force to deal with the thrift industry. This committee, which I chair, includes a distinguished group of industry leaders. It will be making recommendations shortly to the Governor. The dimensions of the problem greatly exceed the capacity of the States.

H.R. 5568 provides a means of continued existence for thrifts that, one, are most troubled, but, two, exhibit a realistic potential for future viability. It provides this means through guarantees of net worth at a minimum level of 2 percent of assets, without committing the Federal Government to cash expenditures unless a guaranteed institution should actually fail.

The assistance proposed would serve to bolster institutions during the current period of high interest rates, giving them the time to amortize their existing mortgages, existing mortgages, and thereby have access to funds that they can invest at higher yields.

In spite of our preoccupation with the problems of the thrifts, it would be unwise and unfair to expect the Federal Government to infuse any substantial amount of cash into this industry when record high interest rates are affecting every sector of the economy.

A record number of industrial bankruptcies are occurring that could have a major impact on public and investor con
sides, I do not believe we can justify adding any more to

al deficit than is absolutely necessary, at a time when we are asking participants in food stamps and other social programs to accept cuts in their levels of assistance.

Mr. Chairman, not only do we need H.R. 5568, but I submit that it makes good economic sense. One of the alternatives is the continued ad hoc merger of ailing institutions, a course of action that Wharton Econometric Forecasting Associates last week estimated would cost the Treasury $84 billion over the next 3 years.

Assuming this, neither the insurance funds nor the banking system can afford costs of this magnitude. Although H.R. 5568 cannot be expected to obviate all supervisory mergers, I would hope that it would substantially reduce the number.

Another alternative is the use of accounting procedures referred to as purchase accounting, which give the appearance of an increase in the earning power of an institution but in reality produce false earnings.

In my opinion, this solution is fraught with danger, since the merged institutions' true financial condition is masked. If these institutions fail in the future, the liabilities of the FDIC and FSLIC will be greatly increased. It could endanger the position of creditors and severely shake public confidence. I must remind you that in New York, when a State-chartered institution's net worth hits zero, I am legally required to close it down. I can only accept some of the accounting practices currently in vogue, which I characterize as highly questionable, if they are coupled with a guarantee of all the liabilities of the bank.

Our recent experience in New York State underscores the need for legislation like H.R. 5568. Since November 1981, there have been five mergers of State-chartered savings banks that required FDIC assistance.

They included, in the aggregate, $9.3 billion of assets and $7.6 billion of deposits; 1.4 million depositors were involved. In population size, that is the equivalent of Metropolitan Cincinnati, Kansas City, or Buffalo. We were fortunate, I believe, in that not one of these depositors was inconvenienced for a minute, nor did one of them lose a single dime.

The five proud institutions we merged were pillars of community service. They survived the Civil War, Great Depression, bank holidays, world wars, only to succumb to high interest rates.

We merged the New York Bank for Savings last Friday on its 163d birthday. It was the oldest savings bank in the State. It was created by special action of the legislature in 1819. It was first to receive a perpetual charter. It was the first to issue a passbook.

I would like to share something with you. I would like you to see the proud history of the bank. We brought with us the first ledger, which shows the depositors where individuals deposited $1, $2, $5, in order to protect their future.

I brought this book from New York, with me, and you may look at it if you like. I have also brought a history of the bank, which the bank gave us, which has been printed for your records.

The disturbing trend of these mergers, however, is that deposits c ıtinue to flow out of the merged institution, indicating a slow ıd a loss of public confidence.

Mr. Chairman, we in New York have taken, and will continue to take, action to preserve the thrift industry. My experience over the past year has certainly convinced me that H.R. 5568 would be highly supportive of our efforts. I would like, however, at this time to suggest several initiatives that I believe might strengthen the bill.

First, let's look at viability. H.R. 5568 would extend guarantees only to institutions that demonstrate reasonable prospects for long-term viability.

Who is to determine viability? In my opinion, that person should be the primary regulator, working in close cooperation with the insurer, the FDIC or the FSLIC. In all modesty, I believe, I know more about the chances for survival of New York State-chartered institutions than anyone at the Federal level of Government.

I am in constant communication with the institutions I regulate. In addition, the State banking department, which I head, has been keeping track records, generating computer models, and monitoring deposit levels, long before it was publicly acknowledged that there was a real thrift problem.

We know the management capability, and the competitive situation, intraindustry and interindustry, in our communities. I am sure my counterparts in other States also do. For those institutions that we regulate the determination of viability should be ours, or, at the minimum, shared.

If the primary regulator is to be given this responsibility, though, he or she has an obligation as well. There is, of course, nothing that we or bank management can do to bring down interest rates.

But the regulators must take the initiative to see that viability is insured by seeing to it that costs are reduced as much as possible to minimize the financial assistance needed from the Federal Government.

We must take this action, additionally, to make sure that Federal insurance funds are protected to the fullest extent. This, I believe, is a major way in which State regulators can save the taxpayers money, and guarantee that, if Federal dollars must be spent under H.R. 5568, they are spent after all other courses of action have been exhausted, and the degree of assistance is the minimum required under the circumstances.

Unless interest rates rise to an even higher level, I do not see a need for any other major assisted merger in New York State until much later this year.

Between now and then I expect to be talking personally with both the strong and weak thrifts within my jurisdiction. Call it preventive medicine, but together with them, I intend to explore every possibility. We have held meetings to explore joining strong thrifts, and making a combined stronger institution.

In that way we plan to create potential acquirers for our weaker constituents. Mergers, in other than crisis situations, can produce institutions requiring less assistance when they are called upon, in the crunch, to absorb an ailing one.

It might very well be that some urban areas, in New York and elsewhere, are overbanked.

Chairman GONZALEZ. Excuse me, I hate to interrupt you, but we have a very important recorded vote coming up.

So, we intend to recess for 10 minutes to allow every member to be present and record his vote and return.

[Recess.]

Mr. VENTO [presiding]. The subcommittee will come to order, the guests will take their seats and refrain from audible conversation, so we can hear from the gentlelady from New York.

Ms. Siebert, would you care to take up where you left off? We apologize for the lengthy delay. However, we had a string of votes.

Ms. SIEBERT. Thank you for the opportunity of continuing.

The last paragraph I had talked about went into the fact that we have held meetings on the need for joining strong thrifts together so that they can take over the weaker ones and require less assistance then they would without the merger of stronger institutions.

It may very well be that some urban areas in New York and elsewhere are overbanked. Perhaps some branches can be consolidated, or even closed. Certainly, economies of scale can be effected, in such operations as advertising and data processing. The physical size of branches can be analyzed, and action taken to reduce both space and personnel requirements.

In this regard, let us recognize the fact that almost two-thirds of thrift deposits are now time deposits, which do not need constant servicing. While overhead is not the basic cause of the problem, and its reduction cannot provide the ultimate cure, more effective management of these expenses can reduce the amount of Federal aid that might ultimately be required.

I realize that this is very hard medicine. Still, if the industry is to survive, sacrifices must be made. I believe all State regulators should be looking for ways to improve the viability of the institutions for which they are responsible, through merger or improved management techniques, or both.

In rural areas, however, mergers may not be feasible. Direct infusions of Federal funds may be the only means of support for some of these thrifts. If, however, we can take measures to improve the viability of the institutions in our urban areas, we will be able to afford the expenditures helping communities which only have a few banks.

I would like to add that I do not consider H.R. 5568 the substitute for the direct infusion of funds, when needed, on the part of the Federal insurer. There will indeed be cases when circumstances will dictate this course of action, regardless of the ratio of the institution's net worth of assets.

I note also that H.R. 5568 stipulates that 50 percent of net new deposits in assisted institutions must be invested in residential mortgages. Personally, I would raise this ante to 60 percent if new mortgage instruments are used.

If we are to justify this legislation, we must justify the usefulness of thrift institutions in American society. They must continue to be, as they have been in the past, the principal source of home financing for the American family.

I would, however, suggest that if there is to be any mandated spread, the rates charged for these mortgages be pegged at 2 percent, rather than 1 percent, above the marginal cost of funds.

Studies indicate that 1 to 1.5 percent is the break-even point for most thrifts. The 2-percent spread should encourage a greater

availability of mortgage funds by providing the opportunity for the institution to make a profit on these loans to offset losses on existing mortgages.

I would also like to make an exception to the requirement that 60 percent of net new deposits be channeled into home mortgages. That exception would be those thrifts that have engaged in heavy borrowing to meet liquidity requirements or to cope with deposit outflows.

They should be allowed to ease the strain they are currently experiencing by using net new deposits to reduce this indebtedness. This is an issue I have pursued separately in terms of arbitrage limitations in tax-exempt housing funds.

In this respect, I would hope this committee would propose, as part of the legislation being considered, the provision that the Treasury Department issue letters of credit to thrift institutions.

Today, many of these institutions are paying premium rates when they must borrow funds. In addition, dealers are refusing to do further business with many thrifts. They are not rolling over existing commitments despite the fact these loans are fully collateralized.

The demise of the Greenwich Savings Bank, our first supervisory merger, was precipitated by the refusal of a consortium of foreign banks to renew its outstanding loan. I believe that a Treasury Department letter of credit might have averted this action.

On a more general basis, I am convinced, a letter of credit can result in increased borrowing power for thrifts, and specifically at lower rates. Most important, the letter of credit concept would result in no immediate cash commitment on the part of the Federal Government.

Lastly, and as an additional means of expanding the availability of credit for thrift institutions, I suggest that the legislation empower the FDIC and the FSLIC to insure all deposits at all banks, regardless of the size of the deposit.

Many thrifts depend on Jumbo CD's, those in excess of $100,000, for much of their funding. Such a guarantee would help reduce the cost they must pay for these dollars.

In summary, Mr. Chairman, H.R. 5568 recognizes the seriousness of the problems of the thrifts and is evidence of a serious attempt on the part of Congress to do the best that can be done, in the current economic climate, to assist, in its time of need, an industry that has made such a substantial contribution to home financing in America.

Mr. St Germain. Thank you, Ms. Siebert.

Now, we will hear from a pinch hitter, Mr. Tiernan, who is here on behalf of the——

Mr. LaFalce. Mr. Chairman, if I may interrupt you for a second. It is my understanding, and I could be incorrect, that Ms. Siebert had to take a 4 p.m. flight.

Ms. Siebert. I have changed it.

Mr. LaFalce. OK.

Ms. Siebert. I think it is too important.

Mr. LaFalce. Thank you, Mickey.

Mr. St Germain. I am sorry, I didn't know anythi

Where am I now?

Mr. Tiernan, representing the National Association of State Savings and Loan Supervisors. Your entire statement will be in the record, and you may proceed.

STATEMENT OF RAYMOND A. TIERNAN, GENERAL COUNSEL, NATIONAL ASSOCIATION OF STATE SAVINGS AND LOAN SUPERVISORS

Mr. TIERNAN. Mr. Chairman, members of the subcommittee, my name is Raymond Tiernan, general counsel of the National Association of State Savings and Loan Supervisors.

I am appearing instead of Mr. Madsen. Mr. Madsen asked me to apologize to the subcommittee and express his sincere regrets for not being here in person.

The Arizona State Legislature is conducting hearings of their own. As such, Mr. Madsen was required to stay on in Arizona for a culmination of these hearings today.

Mr. ST GERMAIN. That is a very dramatic example of the dual banking system.

Mr. TIERNAN. Indeed it is, sir, hopefully in its finest light.

We welcome this opportunity to present to you the views of the National Association of State Savings and Loan Supervisors on H.R. 5568, the Home Mortgage Capital Stability Act.

NASS & LS is comprised of the State officials who regulate State-chartered savings and loan associations in 51 States and territories. Our members supervise and examine over 2,000 State-chartered institutions with assets of approximately $150 billion.

As State supervisors, we are primarily concerned with the preservation of the dual system of financial institutions regulation. The dual system of savings and loan regulation and choice of chartering authority has been the lifeblood and vitality of competition within the Nation's financial institution regulatory structure.

As regulators, we are concerned about the impact of the present economic decline upon our Nation's depositories. Specifically, we are worried about the advent of interstate combinations and industry concentrations which are accelerating at an alarming rate.

Centralization of the Nation's financial resources is a threat to the very system which has served this country so well. Although we feel that deregulation, in time, will move the financial markets into free competition, the irreversible disruption that has occurred under the guise of husbanding Federal resources has anticompetitive effects which have in no way begun to be measured.

It is imperative that the thrift and banking industries survive as distinct entities, serving the various distinct needs of the American public.

Savings and loan associations, for nearly 50 years the primary suppliers of home mortgage credit, are facing severe financial strain. Low-yielding mortgage loan portfolios which do not produce sufficient income to compensate for increasingly high savings costs have forced interstate and intraindustry solutions to the problems of exhausted reserves and net worth.

In H.R. 5568, we see the foresightedness of Chairman St Germain this subcommittee in proposing an affirmative step toward relization of the thrift industry. The thrifts are in desperate

need of a program which will provide capital assistance to bolster declining net worth. We applaud this subcommittee and the sponsor for expeditiously acting in the public interest to preserve the safety and soundness of the Nation's financial institutions. H.R. 5568 will effectively reduce the number of supervisory emergency solutions, prevent the imprudent concentration of economic power in select financial institutions and preserve competition among all depositories.

We furthermore endorse Chairman St Germain's proposal that H.R. 5568 be amended to substitute net worth guarantees in lieu of direct capital assistance involving cash outlays. It is the only solution which we believe can generate the necessary immediate support to ensure its enactment during this session.

H.R. 5568 will help assure that depository institutions are operated in a safe and sound manner, and that prudent underwriting standards are maintained in the origination and servicing of residential mortgage loans. A capital assistance program using net worth guarantees will assure that some semblance of the status quo is maintained until a more comprehensive examination of financial institutions restructuring can be completed and necessary legislation enacted. Thrifts will then have the opportunity to return to a position of profitability.

We submit that any capital assistance legislation should also assure preservation of the dual system which has been the vitality of the American political system since its inception. To preserve the choice of chartering authority for savings and loan associations and to maintain the dual system's checks and balances upon which the principle of federalism is founded has always been in the public interest.

The public interest is today, however, suffering the deleterious effects of increased concentration and combination of depository institutions occurring in an environment characterized by a severe lack of time and funds.

Capital infusion through net worth guarantees will assist thrifts in maintaining reasonable capitalization levels and will thereby permit the Congress to consider the issues of interstate and intraindustry combinations in a more orderly fashion. Although H.R. 5568 will enable a more rational and reflective examination of the question of deregulation of the financial services industry, it should not be considered a cure-all for the problems facing the thrift industry today. H.R. 5568 is only the first step of many steps which will have to be taken if the thrift industry is to be preserved as America's primary home mortgage lender.

Passage of H.R. 5568 would be an endorsement of the thrift industry. Providing Government assurance of the continued viability of the industry through net worth guarantees, will reaffirm this Nation's commitment to housing and preserve a stable supply of housing finance.

We would submit to this subcommittee that capital assistance through net worth guarantees will create no new obligations for the Federal Government. The savings and loan industry has substantial assets and, within the last 18 months, has achieved a satisfactory level of liquidity. What the industry needs is interim measures to buy the time necessary for portfolio restructuring.

We reiterate that we are not asking the Congress for a direct capital bailout; however, we strongly endorse the proposed net worth guarantee for depository institutions as a realistic approach to the near-term problems of net worth capital erosion. Net worth guarantees will assure the direction desired by Congress and the administration toward free market competition with minimum governmental intrusion. The program will provide the vehicle through which thrifts will be given the time to restructure and become competitive. Capital infusion, implemented through net worth guarantees, will enable distressed depositories to survive their present crisis. Through State and Federal cooperation, all regulators will be able to develop a rational approach to deregulation—one which recognizes the need to address market fluctuations and assess projected effects of all variances of interest rates on institutions in a deregulated environment.

In conjunction with our commitment to the dual system, we strongly recommend H.R. 5568 be amended to require State supervisory concurrence in determining eligibility criteria for assistance. Following the FSLIC determination of eligibility as detailed under section (2)(A–C), we deem it essential to the effectiveness of the program that any assessment of State institutions under section (2)(D) include input from the institution's primary supervisor.

The State supervisor is expert in evaluating management resources and local market areas, determinations which cannot be made with accuracy by a computer terminal in the District of Columbia.

Not all wisdom emanates from the banks of the Potomac. Our intimate knowledge of management and operations of these institutions will be invaluable in determining whether the institution has the resources and long-term capability to remain viable.

It is difficult, however, to extend our full cooperation to our Federal counterparts when they promote a policy of mandatory charter conversion. We will oppose any requirement for a State-chartered institution to convert to Federal charter in order to qualify for any form of assistance. The FSLIC has repeatedly required conversion of charter as a condition of FSLIC assistance in interstate combinations. This approach severely undermines the dual system of financial institutions regulation. To be effective, all assistance to qualified institutions must be undertaken through the cooperative efforts of both State and Federal regulatory authorities with a minimum of preemption of State law and Government intrusion.

It is the goal of the administration and the new federalism to deliver authority over State interests and programs back to the State legislatures and administrators and any capital assistance plan must be constructed with that goal in mind.

H.R. 5568 will cost the Treasury nothing to insure the net worth of declining depositories, and, more importantly, it will alleviate the disruption of the financial services market which of late has been severely distorted. The combinations now taking place are not responsive to local residential finance needs and increase anticompetitiveness resulting in a dangerous concentration of fi-[illegible] and economic resources. Deregulation was intended to pro-[illegible] competition and may well have the opposite effect. Thrift in-

stitutions, the disadvantaged participants, require transitional tools. H.R. 5568 is a tool which is needed today. Additional tools including expanded deregulation of investment authority, low-yielding mortgage loan warehousing, and interest rate mortgage buy downs should also be considered by this Congress.

Housing subsidies, in the form of interest rate buy downs, is the preferable vehicle through which affordable housing may be provided to the American people. We cannot support, in its present form, the requirement of H.R. 5568 that while capital assistance or net worth guarantees are outstanding, institutions must make residential mortgage loans at below market interest rates.

This requirement will preclude any participating institution from achieving revitalization. We submit to this subcommittee that our institutions cannot afford to make below market mortgage loans and at the same time offer new ceilingless instruments to attract savings inflows. This requirement will have a detrimental impact on any new growth and is unreasonable.

This subcommittee must act to protect the independent identity of the savings and loan industry and insure a stable supply of housing finance for future generations. A Government guarantee of net worth, at this time, will permit the doors to remain open long enough to preserve the specialized corporate form of the thrift institution and, thus, reduce the adverse structural impact resulting from large-scale combinations of distressed institutions.

Our mandate as regulators is to preserve and protect the institutions which we supervise. We can only do this if given the opportunity to participate in the rehabilitative and regenerative process. Cooperation among all financial institutions regulators is essential to preserve the thrift industry.

In closing, we reaffirm our support for this legislation but ask that this subcommittee amend this legislation to provide for capital assistance through the use of net worth guarantees and to require the concurrence of State regulators in all decisions regarding the eligibility of qualified depositories.

Thank you for permitting us this opportunity to share our views with you.

Mr. St Germain. We are happy to have you, with this testimony.

Now, I will call on the distinguished gentleman from the great State of New Jersey, to introduce our next witness.

Mr. Minish. Thank you, Mr. Chairman. Mr. Chairman, and colleagues, it is my pleasure to introduce the new commissioner of banking of the State of New Jersey.

Mike Horn, in the short period he has been the commissioner of banking, has been very active, and all of the reports that we get are very good. I don't know what else to say, Mr. Chairman, because I didn't have an opportunity to read your your testimony. I reserve my judgment.

STATEMENT OF MICHAEL HORN, COMMISSIONER OF BANKING, STATE OF NEW JERSEY

Mr. Horn. Thank you, Congressman Minish. I am the commissioner of banking of the State of New Jersey, and I appreciate the opportunity to appear before you on H.R. 5568.

Congressman St Germain, I am deeply troubled by the financial condition of our thrift institutions. I am even more troubled by industry opinion that there are not only insufficient assets in the insurance funds to provide for liquidations of failing institutions, but also insufficient assets to provide even minimal assistance in assisted mergers, particularly those supervised by the FSLIC.

Apparently, the Congress is now beginning to come to grips with this enormous contingent liability by the passage of the full faith and credit resolution.

Although I am confident that both the FDIC and FSLIC are consciously and imaginatively dealing with supervisory mergers, their limited funds have led to solutions in some cases resulting in back door interstate banking.

It should be Congress itself, which has both the resources and input to make the difficult decisions on this issue, rather than the insurance agencies, acting under the limited time and fiscal constraints involved in dealing with failing thrifts.

Assistant Treasury Secretary Roger Mehle discussed such legislative approaches rather than administration in his testimony before this subcommittee.

Further, individuals do not always differentiate between different types of financial institutions. Each time a troubled thrift is merged, the attendant publicity erodes confidence in all financial institutions. As the rate of failure increases, this erosion could be devastating. Some have already perceived a quiet run on some financial institutions.

Also, the current plight of our thrifts is one of the reasons that the Depository Institutions Deregulation Committee has been reluctant to carry out its mandate; preventing both commercial banks and thrifts the opportunity to compete with money market funds. Legislation assisting the thrifts would give the DIDC greater freedom to address deregulation in an unhampered fashion.

For the foregoing reasons, I feel that the dialog opened by H.R. 5568 is desirable. Federal Home Loan Bank Board Chairman Pratt's statement to this subcommittee indicated also that enhanced Federal presence in some form may be a prudent step.

I would like to add to the dialog by making the following suggestions for improvement to the bill:

First, the interest rate limitations would be counterproductive. As Assistant Treasury Secretary Mehle noted before this committee, that provision of the bill would actually exacerbate the problems the bill is designed to help. If indeed there is a future to thrift institutions, it will not come about by requiring them to make unprofitable loans.

Second, State regulators are equally concerned with the safety and soundness of the thrifts. I would suggest that H.R. 5568 be broadened in a manner which would permit the States, in concert with the Corporation, to determine eligibility for assistance under the program. A joint effort would enhance the probability that the intent of H.R. 5568 is carried out. For example, in New Jersey we recently enacted, on a bipartisan basis, cross-industry merger legislation. This legislation has and will give my department and the i ring authorities jointly additional tools and flexibility in find- solutions.

Third, as Chairman Isaac indicated, controls should be provided preventing the legislation from being used to subsidize loss from portfolio sales, regulating compensation increases, and also providing for termination of payment to institutions which cannot be salvaged.

Fourth, I would also support consideration of Chairman Pratt's suggestions on formulas for assistance which would encourage cost cutting.

Fifth, Mr. Sponsor and members of the subcommittee, I believe that with assistance of legislation similar to H.R. 5568, which will enable thrifts to buy time, thrifts can eventually survive the crisis and return to profitability. I do not, however, believe that such aid is necessarily incidental to restructuring of thrifts into commercial lending areas and thus creating part thrifts, part minicommercial banks. If thrifts are worth preserving, and I do believe that they are, they are worth preserving as thrifts. The current use of rate-sensitive mortgage instruments shows that home mortgages can be made profitably, and therefore, thrifts do not need commercial lending powers to survive on a long-term basis. I do agree, however, that thrifts will ultimately need the power to compete with money market funds with an unregulated transactional account.

Mr. Chairman, I thank you and the members of this subcommittee for the opportunity to present my views. I would be pleased to answer any questions members might have.

Chairman GONZALEZ. Joe, I want you to know he is not bad.

Mr. MINISH. I told you that. Thank you, Mr. Chairman.

Mr. ST GERMAIN. As a matter of fact, I think he is a rather gutsy individual. I refer to your statement. I don't know if the members of the committee caught this right at the end.

> I do not, however, believe that such aid is necessarily incidental to restructuring of thrifts to commercial lending areas and thus, creating part thrifts, part minicommercial banks.
>
> If thrifts are worth preserving, and I do believe that they are, they are worth preserving as thrifts. The current use of rate-sensitive mortgage instruments shows that home mortgages can be made profitably, and therefore, thrifts do not need commercial lending powers to survive on a long-term basis.

I have a good memory. And other than those who opposed commercial lending powers for the thrifts, with understandable reasons, I think you are No. 1 in your category to make a statement such as this.

Maybe it is because—I don't say this in a derogatory fashion—you have just been on board 55 or 60 days. What do you think of that statement, Ms. Siebert?

Ms. SIEBERT. The savings we gave the savings banks in New York State, the right to put up 20 percent of their assets into consumer loans or not mortgage loans of which one-fourth or 5 percent could be in commercial loans.

Mr. ST GERMAIN. Which is in conjunction with what we did on a national basis?

Ms. SIEBERT. Yes, we played catchup, so to speak. If the banks would have had these powers, if they had these kind of loans, I think they would be in better shape, because they would have had loans that reflected the cost of money.

The new mortgage instruments today—and I believe that the new mortgage instruments will be the only kind that are written, the ones that go up with the cost of money, will enable the banks to make money on these instruments.

I do feel, though, that banking is changing and the whole financial structure is changing in this country. The current savings banks or thrift institutions will end up as the one-stop shopping banks for individuals in the future.

It will be the community bank for people issuing the automobile loans, the credit cards, but especially they will stay mainly in financing and mortgages.

Maybe that is a long answer for a short question.

Mr. St Germain. I would ask Mr. Tiernan and Mr. Malarkey if they would, for the record, also address that particular question in writing, rather than at the present time.

[In response to the request of Mr. St Germain, the following correspondence was received for inclusion in the record:]

OFFICE OF THE EXECUTIVE VICE PRESIDENT-SECRETARY

April 12, 1982

Honorable Fernand St Germain
Chairman
House Banking Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman St Germain:

In my appearance before the Subcommittee on Housing and Community Development, you requested that I submit in writing additional comments expanding my thoughts on the role of state supervisors in a successful capital maintenance program, the type of changes needed in the mortgage reinvestment provisions of the bill and the future of housing and the thrifts. My answers to your questions are detailed below.

State Determination of Viability of Institution

In our testimony, we endorsed a stronger role for state supervisors in the determination of an institution's viability. In conjunction with the stronger role we also suggested criteria which would help tighten the qualifications for entry into the program.

We have stated that an institution's eligibility should, in part, be determined "by requiring that the primary regulator determine the institution's long-term viability, determine that the institution would have to be closed within the next 12 months without such aid, but would live with it, determine that the institution's losses have been caused by governmental action rather than mismanagement and that management of the institution is committed to its survival."

CSBS supports implementing this approach by providing for initial review of viability under the criteria of the statute by the primary supervisor (state or federal), with right of appeal of a denial to the insuring agency and with an override of the initial decision by a unanimous vote of the board. Such an approach would avoid adverse effects resulting from arbitrary action by either primary regulators or insuring agencies. It

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would involve those most familiar with the day-to-day regulation of the institution in the eligibility process and reduce the increased work load to which Chairman Pratt referred in his prepared statement of March 24 (page 18).

Provisions For Profitable Mortgage Lending

Pursuant to your request, CSBS staff has been in contact with Committee staff in regard to two suggested technical changes. First CSBS suggested that at least 60% of new deposit funds be required to flow into real estate loans and related activity rather than the 50% in the proposed bill However, as a result of conversations with staff, CSBS would also suggest that the limitation to first time buyers also be eliminated so that a broader base of thrift institution growth can be realized.

The second technical change involved our request that depository institutions not be required to make these loans at 1% or less over their average cost of funds Over the last decade regulators and bankers have learned all too clearly and painfully that the marginal cost of new funds is more critical than average cost of total funds in calculating the interest spread that must be earned in order to be profitable They have also learned that average margins of 1% or less would "break" traditional depository institutions. CSBS believes that no limit should be placed on interest rates for these real estate loans and that competitive forces resulting from a number of institutions striving to place 60% of their new funds into the market will be sufficient protection for the consumer If institutions can make a fair profit, real estate lending will return. Our staff will be developing some marginal cost estimates at the request of your staff.

Preserving Thrifts As Thrifts

Another witness suggested that "if thrifts are worth preserving ...they are worth preserving as thrifts." Chairman St Germain requested our comments on this issue.

As we stated in our testimony, the Conference of State Bank Supervisors has generally taken a "no policy" stance on increased asset powers for thrifts. CSBS has testified against extending to the thrift industry commercial bank asset powers without equalizing competition and subjecting S&Ls to state authority under the rubric "no homogenization without McFaddenization."

The reasons for not "McFaddenizing" thrifts will no longer exist if commercial lending authority is enacted. The Savings and Loan industry has grown from about $7 billion in assets in 1945 to $620 billion today. While the small, community thrift, like the community bank, still exists, the lack of retention of structural authority by the states in savings and loan regulation has changed the sphere of operation for most thrifts. If "homogenization" is enacted, the allocation of deposits to housing will no longer be of tantamount importance. In fact, if, as some have argued, the new asset-side powers are necessary to the survival of the thrift industry, reason will dictate that well-run thrifts would infuse most, if not all, of their new assets into other than housing in direct competition with commercial banks.

Historically, the thrift industry was not subjected to similar statutory provisions because of its role as a specialized, even "preferred," institution. The nation's interest in maintaining a thriving housing industry was deemed to override, in the limited context of authorized thrift operations, the concerns with concentration of financial resources. Moreover, financial concentration was not feared in an industry which, by nature of its "specialty," operated largely on a local level; local money was allocated by local institutions. Where deposits gathered by an institution have been by-and-large allocated by the statutory nature of the institution, safeguards against control of the allocation process need not be stringent.

The Conference of State Bank Supervisors recognizes the important policy issues attendant with homogenization. As regulators, our role is to maintain a fair, safe and sound intermediary system which can serve the current and future needs of both savers and borrowers. From our collective experience we know of the difficulties of establishing and operating individual lending institutions; creation of a new home mortgage lending industry could not be done overnight. Thus, while it is beyond the scope of the Conference to address the social policy question of who should make mortgage money available to future home buyers, we certainly realize that the Congress is facing a valid and important question when it addresses that issue.

If you have questions concerning my responses or have any additional inquiries, please feel free to contact me or CSBS staff. Recognizing the importance of this legislation, we will make every effort to be responsive.

Sincerely,

John E. Malarkey
State Bank Commissioner
Delaware

JEM:dr

National Association of
State Savings & Loan Supervisors

Voice of the State Chartered System

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April 15, 1982

The Honorable Fernand St Germain
Chairman, House Committee on Banking,
Finance and Urban Affairs
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

On March 31, 1982, the National Association of State Savings & Loan Supervisors ("NASS&LS") testified before the House Banking Subcommittee on Housing and Community Development with respect to the Home Mortgage Capital Stability Act, H.R. 5568 (the "Act"). During the course of our testimony you and members of the Subcommittee raised several questions which you asked that we respond to in writing. This letter is in response to that request. Set forth below is a summarization of the questions posed and our response thereto. We have also taken this opportunity to reemphasize our position that the Act be amended to provide for a concurrent determination of "viability" by the Federal Savings and Loan Insurance Corporation ("FSLIC") and the state supervisor where an insured state chartered institution is involved.

I. Does NASS&LS object per se to the proposed requirement that "qualified institutions" which receive a capital infusion invest 50% of their annual net new savings deposits in residential mortgage loans, or is NASS&LS' objection confined to the imposition of a requirement that the residential mortgage loans be made at an interest rate equivalent to 1% above the institution's average cost of funds?

The National Association of State Savings & Loan Supervisors is primarily concerned with assuring and promoting the safety and soundness of the savings and loan industry, in general, and of state chartered institutions, in particular. In fulfilling our commitment to that goal we are most concerned that the proposal that an assisted institution shall be required to invest 50% of net new savings in residential mortgages at an interest rate not to exceed 1% above the institution's average cost of funds will simply compound the industry's

principal problem of low yielding long-term assets and adversely affect the institution's financial condition. As a philosophical matter, [illegible] strongly supports the commitment of the savings and loan industry to continue to be the nation's principal provider of home mortgage finance. As such, we support the requirement that 70% of net new savings be invested in home mortgage loans. Moreover, we acknowledge and endorse a primary goal of this legislative proposal: the revitalization of the housing industry. However, we do not support the proposed requirement that the net new savings be invested in mortgages made to first-time home buyers. While the promotion of home ownership is a most laudable goal, the proposed requirement will not only be difficult to administer but such purchaser restrictions will also have a detrimental impact on home building and prudent loan underwriting.

II. <u>Is there a need to expand the investment authority of thrift institutions or should they be preserved in their present form?</u>

Deregulation of financial institutions is, as a result of Congressional and regulatory action, economic forces and technological change, a reality which the thrift industry must face. In our opinion, the savings and loan industry has accepted this fact and is now rapidly trying to restructure and position itself in order to be able to compete fairly in a deregulated financial services marketplace. An integral part of the thrift industry's restructuring is having the ability to offer the many varied services which its competitors will be offering. Expanded investment authority for the savings and loan industry does not translate to mean abandonment of home financing by the industry. Rather, it will afford savings and loan associations the opportunity to more evenly match their asset-liability structure. The savings and loan industry's expertise in the field of home finance and its historical commitment to housing clearly indicate to us a natural continuing commitment to housing.

Finally, we would like to reiterate our position on what we believe are two issues crucial to the preservation of the dual system of financial institution regulation. First, we would like to re-emphasize the need for concurrent supervisory determination of eligibility criteria for assistance to any insured state chartered institution. As previously stated in our testimony, we believe that the success of any capital assistance program depends upon input from a state chartered institution's primary supervisor. The synergy of a concurrent supervisory determination will enhance the capital assistance program. Our intimate knowledge of management, operations and local market areas of these state chartered institutions is invaluable in any determination as to whether these institutions have the resources and the long-term capability to remain viable.

Secondly, although the act does not speak to the issue of mandatory charter conversion, we are deeply concerned with the Federal Home Loan

Bank Board ("FHLBB") policy to require, as a step incident to the receipt of capital assistance or participation in the "Phoenix" program, the conversion from state to federal charter. The FHLBB justifies this mandatory charter conversion on the FSLIC's need for flexibility in regulating distressed institutions as federally chartered associations in order to protect the integrity of the insurance fund. NASS&LS strongly opposes this policy as it is overly broad and as an undermining of the dual system's fundamental commitment to freedom of choice of chartering authority. The flexibility which the FSLIC maintains it needs in regulating distressed institutions can be achieved by far less overreaching means. We submit to you that there is no compelling reason for the policy of mandatory charter conversion.

Thank you for this opportunity to submit our written responses to the issues raised before the Subcommittee. Should you have any further questions or comments with regard to the Act, or other related financial institutions legislation, please do not hesitate to contact us.

Sincerely,

NATIONAL ASSOCIATION OF STATE
SAVINGS & LOAN SUPERVISORS

Clark W. Wideman

Clark W. Wideman
Vice President

Mr. St Germain. I would like to get a few other areas covered. On the role of the State supervisors, all four of you have made it clear that you feel that the State supervisors should be involved.

I would like my staff to work with you people on this. I would be very reluctant to go as far as to say you should have a veto power. I would say strong consultation, important consultation. We might be able to work out something like that.

Would that suffice? Let's start with Mr. Horn.

Mr. Horn. Congressman St Germain, I think at the very least, a requirement that there be consultation, to my mind, would be satisfactory. I would also——

Mr. St Germain. I am talking about making it a statutory requirement.

Mr. Horn. I think that would be an acceptable solution. But while you are on that same issue, it actually works two ways. One is State input, the other is power of the insuring authorities. There has been some talk that along with the ability to give aid, that the insuring authorities—I think it was Mr. Tiernan mentioned, there is an unwritten requirement that there be a conversion to Federal charter.

So, along with requiring at least a statutory requirement of State input, if you as sponsor could somehow look into requirement that the insuring authorities not have additional powers over what they already have, particularly the requirement that there be a conversion to the Federal charter, which I think is very dangerous.

Mr. St Germain. I agree. We don't make any proviso in legislation to date for mandatory conversion and it is not our intent to have such a requirement.

We could either put it in a report, I don't think we would have to make it statutory?

Mr. Tiernan?

Mr. TIERNAN. As that was my statement, perhaps I could clarify the statement in the record.

The process, as it exists today under the FSLIC——

Mr. ST GERMAIN. The merger process?

Mr. TIERNAN. Yes, and frankly, sir, the Phoenix program, as they have put it in place today. As of this date four Phoenixes have been created in which each of the surviving entities have been Federal or federalized.

One association was a State chartered institution prior to being Phoenixed. Having served as counsel to several associations which have been characterized as supervisory cases, I can assure you that conversion to a Federal charter is a mandatory step to being the center of any such Phoenix. The justification for this policy in the need for Federal authority to regulate the surviving institution from cradle to grade.

Mr. ST GERMAIN. Ms. Siebert?

Ms. SIEBERT. I very reluctantly suggested to the banking board of the State of New York and they voted it at the last meeting, that I have the power to stop any conversion of a troubled State-chartered thrift institution to a Federal charter.

I have been told that one of the ways that the FDIC was anticipating dealing with some of our institutions was to insist that they convert to a Federal charter, merge them across State lines into a shell of an S. & L., where they would either make them a stock corporation or sell them to whoever they felt like selling them to.

I very reluctantly did it. It was the only way that I could say that we would have a definite input into the ultimate outcome of our troubled institutions.

Mr. MALARKEY. I think State supervisors have to have some part in this program. I have been consulted a number of times by the Federal agencies and I work with both of them.

Consultation doesn't gain the State supervisor much, sir. We get listened to and then they do what they want.

I think we need a little stronger role.

Mr. ST GERMAIN. Well, I would ask you to consider that in this instance what we are talking about is, a statutory requirement for consultation.

We are going to require that there be a finding that the institution is viable, that is the important thing.

Of what value is it to issue a net worth guarantee certificate to the institution that meets the requirements if it is not going to survive?

And certainly, the input of the State supervisor, is very important, because in many instances, they have probably been closer to those institutions than the Federal agencies.

It is not a question of a merger, or anything of the sort, now. Remember this.

So I think that you should give consideration to the fact that in this instance consultation might well be more important than what you have seen before, because they would have to be able to demonstrate that they have consulted with the State supervisory agency prior to determining that the institution was salvagea so to speak.

Otherwise, they would be in violation of the congressional mandate.

Mr. MALARKEY. OK, sir.

Mr. ST GERMAIN. The whole purpose of these hearings on this legislation is to seek your recommendations and those of the other witnesses.

We are asking you for recommendations for improvements, to tell us where you feel that there are some shortcomings.

Because if we are going to do this, we want to do it in the right manner. There is no pride. We repeat again, our feet are not set in concrete on this.

We are just trying to come up with the best piece of legislation possible. It will be reintroduced at the conclusion of this set of hearings so that we have got something that is meaningful and that we avoid any mistakes and pitfalls and I would like to go on, but I want to share the time with my members.

I have a few other questions I would like to propound after the other members have had their turn.

Mr. Stanton?

Mr. STANTON. Thank you very much, Mr. Chairman.

Welcome to this subcommittee. We appreciate your testimony. The divergencies of views that make eventually legislation have been expressed.

We are especially pleased to see Ms. Siebert again. I sometimes think I see you more often than I have seen my wife over the last 3 months. But I do appreciate the interest that you have in your State and the time you spend when you come down to Washington and keep us informed of what is happening. I am very sincere about that.

One question to you, Mr. Horn, maybe you have the answer. I read the future of your thrift industry a little bit different from our chairman.

If you just have this answer, we can solve this thing. You do agree, I am quoting you, that "Thrifts will need the power to compete with money market funds with an unregulated transactional account."

This would be one of the highest paying instruments, wouldn't you agree with that?

Mr. HORN. Yes; that's correct.

Mr. STANTON. Before that, you say that we are certainly in agreement that the thrifts are worth preserving as thrifts. I presume that you mean their role should be to provide long-term mortgages?

Mr. HORN. Not quite, Congressman.

Mr. STANTON. I thought you were taking care of the——

Mr. HORN. I didn't mean long term because long term with adjustable rate, yes. But I meant thrifts for home mortgages.

That doesn't necessarily mean a long-term mortgage unless it is adjustable rate.

Mr. STANTON. Do you think, then, that in this feature that lies ahead of us, that thrift institutions can be profitable—of course, I am sure we would agree on that?

Mr. HORN. Yes.

Mr. STANTON. That can provide money market fund rates and lend long-term variable rate mortgages?

Mr. HORN. Yes; I do, Congressman.

Mr. STANTON. You do, with nothing else?

Mr. HORN. Well, I didn't mean with nothing else. We need H.R. 5568 in some form.

Mr. STANTON. I don't mean that. I mean to enable the industry to stand on its feet.

Mr. HORN. Yes; very clearly so. I meant it when I said that thrifts can lend profitably for home mortgages. And they can do that even with the liability side of having to pay high rates in competition to money market funds.

Once we can get them back to profitable again, they do have long-term viable life ahead of them, if we can get over this serious problem.

Mr. STANTON. In paying money market rates?

Mr. HORN. That's right. I don't know what money market rates are today, but let's guess 13, 13½.

Mr. ST GERMAIN. It is 13⅝ percent.

Mr. HORN. Let's assume 13½, 2 percent spread is all that is needed.

A lot of people would like to have mortgages today at 15½ or 16 percent if they could get them. So I think, yes, that thrifts can stay alive, pay money market rates on their deposits, and make adjustable rate mortgages that would rise and fall with the money market.

Mr. STANTON. One of the smartest people I knew in the savings and loan industry said that if we do nothing to subsidize the industry, in the next 5 years we will lose half of the industry, we will lose 2,000 institutions.

"The 2,000 you have left", he said, "will be the strongest, most powerful institutions in our country?"

What do you think about that?

Mr. HORN. I guess I agree with it—was the statement if we do nothing.

Mr. STANTON. If we do not act with a cash infusion plan and the rest of it, that is proposed at the present time?

Mr. HORN. That we will end up with the strongest institutions.

Mr. STANTON. He thinks eventually—it is a question of how long, 5 years, 10 years—those institutions, with the additional powers, would virtually become banks.

Mr. HORN. I have to disagree with that.

Page 1 of my statement indicates that if we do nothing, there is not enough money in the funds to do what has to be done.

That is what really concerns me. Now I know that the people in this room are aware of the problem or you wouldn't be here and this bill would not have been proposed by Congressman St Germain.

I wish the concern of those in this room would become more pervasive and the administration would also become as concerned as you are.

I think we cannot afford to do nothing. If you read as many statements as I have, doing nothing will be much more ex   ısive later on.

Doing nothing will render the thrift industry as under and bankrupt the funds, in my opinion.

Mr. STANTON. Thank you all once again.

Mr. ST GERMAIN. Mr. Minish.

Mr. MINISH. Ms. Siebert, on page 6 of your statement, you say that just to determine viability, in your opinion, that person should be the primary regulator. In the State of New York, that would be you?

Ms. SIEBERT. Yes.

Mr. MINISH. Well, why should you be the only one to make that determination when the people in Washington are responsible for this?

They are the ones that have to provide the loan if necessary.

Ms. SIEBERT. I realize that. I believe that we know our institutions and banking markets in New York better than the Federal agencies. I could provide that to you because, for example, my department regulates the money market banks, the small commercial banks, the savings and loans, the credit unions, the savings banks, et cetera. I will know more about these entire markets in Buffalo, where John comes from, than the FDIC will, or that FDLIC will, because I have to take into account the entire structure of these markets because we are regulating all of the pieces.

So I feel that I have a better understanding. We have been closer to them. We both see the same numbers, the same examination. We share examinations, we accept their reports, they accept our reports. We also have very high tough standards in New York. I cannot let a bank operate with a deficit net worth. The trustees will go to jail.

Mr. MINISH. It seems to me it will be putting a lot of power in one person's hands. Would it not be better to do it jointly with the people in Washington responsible for this problem?

Ms. SIEBERT. I am in New York. I am only speaking for New York institutions.

Mr. MINISH. Would not the approach of the commissioner of the State of New Jersey be better to do it jointly?

Mr. LAFALCE. We can work out a schedule, one rule for New York and one for New Jersey.

Ms. SIEBERT. I am not attempting to speak for New Jersey. I assume Michael Horn would be able to say.

Mr. MINISH. If it is legislation, it applies to 50 States. I seem to think that is too much responsibility for one individual to have. Mr. Horn has recommended a joint effort to enhance the intention of H.R. 5568 be carried out. I also would like to see a joint responsibility.

Mr. HORN. That is correct. I am not sure that Ms. Siebert disagrees, Congressman.

Ms. SIEBERT. I am saying working in close cooperation with the insurer. I do not like to be told what is going to happen to our institutions. This has basically occurred at times.

Mr. MINISH. Thank you.

Mr. ST GERMAIN. Mr. Evans?

Mr. EVANS. Thank you, Mr. Chairman, and Ms. Siebert and the commissioners here today. It is a special pleasure for me to be here being the lone representative of the House from Delaware. We wel-

come Mr. Malarkey. He is our State bank commissioner for the State of Delaware.

Mr. Malarkey. I would like to comment on your testimony. On page 4 of your statement you say that the best way to insure cost-effectiveness is to target a program narrowly to those who truly need assistance and have a high probability of being saved if they get it.

You will have a very difficult job of determining who does truly need assistance and if they truly need assistance, whether they can be saved. Because the more you need assistance, the less your chances may be of achieving financial health. It is a very difficult job indeed that we will have.

On page 7, you note the thought expressed by the Chairman, Mr. St Germain, that one must oppose thrift aid measures that do not narrowly target funds to those institutions that need them the most, and could be made viable in the long-term by the assistance.

I agree with you. We have got limited resources and I wonder what would happen if we tried to provide assistance on something other than a narrowly targeted base.

I would think that there would be damage to some of the existing institutions that are healthy, if we do not do that, and like I would like you to perhaps expand on that.

Mr. Malarkey. Well, on page 4, the comment you made there, Mr. Evans, is determining whether or not an institution would be viable. I have had a little experience in that, in 1976, in a different position.

Mr. Evans. You sure did.

Mr. Malarkey. I am pleased to say it was a success but it was very costly to both State and Federal Government. Determining viability is part of our job. It is something we have to do. The comment on page 7, I just do not believe you can go out and give aid in a very general nature. You have to target it to those who really need it and to those who, if they get it, will have a very good chance of succeeding. Otherwise, you are throwing a lot of money away.

Mr. Evans. I agree with our distinguished bank commissioner from Delaware. There is no question about that. I just wondered whether you might comment on what would happen to help the institutions if you were not targeting the aid in a more narrow fashion?

Mr. Malarkey. Well, I think I mentioned in my speech here or one of the other people did, the healthy institutions are suffering now, from the lack of public confidence that is beginning to come about. The ailing institutions—without some type of aid, the healthy institutions can be harmed from lack of public confidence.

Mr. Evans. Do any of the other members of the panel care to comment on that particular point? Do you agree with Commissoner Malarkey?

Mr. Tiernan. If I may, Mr. Evans. Certainly Chairman Pratt agrees with Commissioner Malarkey's assessment. In his testimony before this subcommittee on March 25, Pratt stated that we are experiencing a quiet run on the savings and loan industry. I could not concur more wholeheartedly. A recent release of the Fe
Home Loan Bank Board's Office of Policy and Economic Rese

reflects a dramatic downward adjustment in savings flows into the savings and loan industry.

If I may, I would also like to speak to the point on consultation with the State primary regulator. Perhaps a compromise might be, rather than talking in the terms of consultation that we speak in the framework of obtaining concurrence of the State regulator.

That is, that when these determinations of viability are made, that they be joint determinations wherein the State supervisors have the right to concur. In the event concurrence of the respective State supervisor is not received, the statute could provide the FSLIC with the authority to grant capital assistance without such concurrence, provided very explicit determinations and findings are made b the FSLIC.

Mr. HORN. Congressman Evans, you asked for a general comment on your question. I think the question was what does it mean to healthy institutions to provide this?

Mr. EVANS. What does it mean to healthy institutions if you do not narrowly target these resources? I think the answer that Mr. Malarkey gave me that this would be harmful to the healthy institutions was correct.

Mr. HORN. I would agree with that as well. No one is entitled to aid and that it should be targeted, I think in the long run that benefits all.

Mr. EVANS. Thank you.

Mr. ST GERMAIN. Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

First, if I may exhibit just a little bit of pride, Mickey has done a tremendous job in New York. One of the financial institutions that has enabled her to come out from under in this situation happens to be the Buffalo Savings Bank, which is now the largest savings bank in the United States of America. It took over Western, over Union Time, over New York Bank for savings.

I thought that was going to be syndicated, I was a little surprised when they took the whole thing over. I am just pleased that other local savings bank has been deemed strong enough, well-managed enough, to be able to have been of such help in these troubled times.

Mickey, let's suppose we have passed some variation of H.R. 5568. I have a number of questions. Primarily, this is going to buy time. Time is very important. The question is how much time would it buy, it depends of course upon the economic circumstances, but assuming the interest rates stay basically where they are at now, how much time would it buy?

Would it prevent you from having to assist other financial institutions in New York at the end of this year, as you presently anticipate? What else might be needed? Will we still have to pursue a warehousing program for below-yield mortgages, et cetera?

Ms. SIEBERT. This would buy time which will not inherently strengthen the institution but will hopefully carry it past this travesty as I call it. If interest rates stay at this rate, we need this bill. This will only enable the institution to stay alive through a paper transfusion. We will need a warehousing, or we will need the ability of these institutions if it works to sell a tax-exempt certificate

backed by mortgages to maybe get these low-yielding mortgages out of these portfolios and help the institutions.

It may be an extension of modifications because it has tied the hands of the mortgage agencies, Sunny Mae, which has gone ex officio. The targeting restrictions are so tight in the Ullman-Conable regulations that we were only able to issue one issue last year, so far nothing this year.

So there are various things. I think the letters of credit to bring down the costs of borrowings, the repo dealers, many of our banks take their securities, their GNMA's, their FNMA's, they pledge them with security dealers getting cash, which they use to meet outflow. These are called repos.

The dealers have not been rolling them over.

Mr. LAFALCE. Would it be helpful if we changed the tax laws to permit a long perod of years for writing off a loss on mortgages?

Ms. SIEBERT. That is one of the new forms of accounting which the FSLIC has introduced. There are inherent troubles in that, John. You are allowing them——

Mr. LAFALCE. That is different from purchase accounting?

Ms. SIEBERT. Yes, but they both mask the inherent intrinsic position of this industry.

Mr. LAFALCE. Let's discuss them both, separately, because I think one might have more merit than the other.

Ms. SIEBERT. If we take mortgages, and allow the institutions to sell them, and maybe the 8.5 percent mortgages now will come in 60 cents on the dollar, and allow them to write off the 40 cents lost over a period of 30 to 40 years, we are basically establishing a good will account which will be amortized over 30 to 40 years. If that institution goes broke or fails within the next—within 2 years, 5 years, 10 years, we have created water in the balance sheet. Somebody is going to have to pick up that water.

To the extent that they can invest those funds at higher yields, they might be able to increase their current income but not enough to offset the writing off of that good will account in what I consider to be a prudent manner.

I cannot sit here and tell you that the thrift institutions are going to be viable in 30 to 40 years. The whole financial structure of this country and of every institution is changing very fast. FSLIC did go along with it and we, in turn——

Mr. LAFALCE. FSLIC did it for all of the assets, rather than just the mortgages?

Ms. SIEBERT. They are doing that in purchase accounting for all of that. I can understand the FSLIC was considering allowing the sale of tax-exempt bonds and allowing that to be written off over the life of the bond, if the proceeds were invested in taxable bonds.

That I would go for. Because, there you are forcing the institution to invest in the same kind of security except a taxable security yields much more than a tax-exempt one. So you are increasing the income of the institution, but the expense—and you are expensing it over the life of that instrument, which in those cases are bonds.

That I think is prudent and that I can accept. Because you are exchanging like for like. But writing off the mortgages over the 30 to 40 years can be very dangerous in the future.

Mr. LaFalce. What is the difference between that and purchase accounting which you spoke of earlier?

Ms. Siebert. Purchase accounting is another method of deferring losses, so to speak. Some of the mergers that FSLIC have used involves purchase accounting. They merge either weak institutions with weak institutions or weak institutions with strong institutions. In either case, they use the same accounting technique. They mark the assets down to market on paper.

In the case of a billion dollar institution, if they discount with 40 percent, you create a $400,000 goodwill account, $400 million goodwill account, which you then amortize over 30 to 40 years.

You will keep the discount on the mortgages. That is you take the discount on the mortgages into income 10 to 12 years. So theoretically, you are shown an income expense ratio of 3 to 4 to 1. You are not adding one dime to the cash flow of this institution, but you are showing a paper profit.

So you can merge weak institutions and show a paper profit on it without doing anything to improve the actual financial quality of the institution.

In my opinion, it masks the true——

Mr. LaFalce. Is anybody doing that though?

Ms. Siebert. They are doing that in the FSLIC mergers. It is called purchase accounting. It has been questioned and is being questioned in the papers and I think it is highly dangerous because it sets up the possibility of very serious problems in 2 or 3 or 4 years.

Mr. LaFalce. How does the representative of the S. & L. association feel about that.

Mr. Tiernan. Well, frankly I do not completely agree with Ms. Siebert on the utilization of purchase accounting. I personally think there is a place for purchase accounting and that institutions should be able to avail themselves of purchase accounting.

This form of accounting was not created by the FLSIC; it is a well-developed accounting principle which has been reviewed by the AICPA and the SEC. On several of the interstate acquisitions in which purchase accounting was utilized, the SEC had primary jurisdiction as the acquirers were publicly traded S. & L. holding companies. Furthermore, their accountants also reviewed and scrutinized the form of accounting method.

I personally think that purchase accounting has a place in the combination of savings and loan associations. I do think it is an accelerated method of income realization. However, I do not think that in and of itself is a necessary evil.

Where we will be in 2 years, 3 years, 5 years, is a question which I do not think any of us are prepared to answer. And at that point in time, these institutions may be better able to dispose of these assets and there will not be the loss that we are talking about. Without question, once you reach about a 7-year point, the utilization of purchase accounting comes home to roost.

I should also mention that the accounting profession, the FSLIC and the SEC have recently taken steps to temper the impact of purchase accounting. For example, if the period of amortization of goodwill is in excess of 25 years, they will require an amortization

method which will accelerate amortization of the goodwill account, which will adversely affect the institution in the early years.

Mr. LAFALCE. For a guy who has to have an accountant do his own tax returns, that was very helpful.

Mr. ST GERMAIN. Mr. Bethune?

Mr. BETHUNE. In the interest of time, I will yield back my time.

Mr. ST GERMAIN. Mr. Garcia?

Mr. GARCIA. I would just like to add to what my colleagues from New York have said about our superintendent of banks.

First of all, it has been a very difficult period for the persons sitting up there and those of us sitting back here. I can think of better times to be on a banking committee and better times to be superintendent of banks.

But the fact is that I think under the circumstances, everybody seems to have held up pretty well. There are a couple of questions I would like to specifically aim at my superintendent from New York. On page 10, you state that a Treasury letter of credit will increase borrowing power for thrifts at lower rates. Would you explain what it is you mean by that?

Ms. SIEBERT. Sure, our thrifts today are paying pretty high rates to borrow. They are paying more, they are paying premium rates for the CD's because the CD's are over $100,000, and they are not insured. So therefore, whenever you have a borrowing that is not of the top quality, you are going to pay more.

There is a risk ratio that comes into play in borrowing. Yet these loans are secured by in many cases, if we are talking about repo lines, if we are talking about the jumbos they are not secured. I think a letter of credit guaranteeing them by the Federal Government or by FSLIC or the FDIC, would bring the cost of borrowing down.

I can tell you that I believe that investors would be inclined to put money into these institutions at a lower rate if they knew they were guaranteed. And reducing borrowing cost is just as good as reducing the cost of deposits.

Mr. GARCIA. Another question I want to ask you involves a bank in Hartford, Conn. If I remember correctly, you [illegible] Hartford National. How was it that superintendent of a bank in the State of New York gets involved with a bank in Connecticut, and exactly what did you recommend?

I am really curious. Unless you are looking to take over national offices or something.

Ms. SIEBERT. I had heard that there was a run on an institution in Connecticut. I picked up the phone and I called and I asked for the chairman of the bank or the president. They did not return my call the first day.

The second day they did return my call. The run was still going on. I asked him what he was doing. He said that he had an [illegible] guard walking people to other banks. He was giving people [illegible] money to go to other banks. He did not want them to get [illegible] walking out of this bank with cash. I told him that we had a list of emergency programs that my department put together because we thought that it was possible that we would get a run.

So I went over all of the various programs that we [illegible] him. are many people taking [illegible] [illegible] they [illegible]

time deposits? Because Wednesday one of our troubled institutions had an $8 million jumbo that took a penalty one day. He said yes, they are. I said, well why don't you get on the radio, get on television, put an ad in and tell them their contracts are insured up to $100,000. If they bring back the deposit, you will forgive the penalty.

He did that, and I have the letter from him thanking me for what I did. So that is how I happened to get involved. I was not trying to take them over.

Mr. GARCIA. Let me ask you another question, if I may. Where was the FSLIC in all of this?

Ms. SIEBERT. He said that they were busy and they had not arranged for the bank yet, and he was having a hard time getting them to address the problem. They have many institutions and this was, you know, they are as overworked as we are at times, and he was having great difficulty in reaching them.

Mr. GARCIA. I don't know if I am satisfied with the answer, but I guess that is the answer.

Thank you, Mr. Chairman.

Mr. ST GERMAIN. Mr. McCollum?

Mr. MCCOLLUM. Thank you, Mr. Chairman.

I wanted to ask a New York question, I guess. I am from Florida, but I have the question because Mr. Isaac raised it the other day.

With regard to the New York franchise tax, he suggested to us that there is a problem in the mutual savings bank area with regard to our helping out. It is based upon the fact that there is apparently a tax in your State which would, in essence, tax volume regarding the viability of these institutions' volume that goes through them.

He expressed a concern that if we followed the procedures set forth in the proposed legislation without putting some kind of proviso in there to waive the tax or require waiving the tax, we may be shipping the Federal moneys into the local coffers rather than helping those institutions the way intended.

Is this a correct assessment? Is there such a tax? To what degree do we have a problem?

Ms. SIEBERT. We have a great problem. I got the tax reduced last year, but not enough. I chair the Governor's task force on the thrift industry. I have a draft of the report with me.

We are going to suggest that the thrift industry pay taxes on the same basis that the commercial banks pay taxes, which is a very, very small franchise tax, not the $90-some-odd million that the thrifts would pay the city of New York and the State.

We will try it again. Frankly, it may cost me my job, but I would be delighted if you put an override on your taxes in the bill.

Mr. ST GERMAIN. You didn't have to say that. We are going to do it anyway.

Mr. MCCOLLUM. We don't want to cost you your job in any event, no question about it.

Do you have some supporting documentation for how much money really is being taken in now from these institutions?

Ms. SIEBERT. About $93 million between the city and the State. It is really disgraceful. I can give you the exact amount.

Mr. McCollum. I will change the subject. The chairman responded, and it sounds like a good repartee right there. At the end of your testimony you indicated that one last thing you wanted us to do was to consider changing the insurance limits of $100,000 in these institutions so that all depositors would be covered or potentially covered.

What would be your response to the objection that some might raise to this. That it would be a step that would remove the last vestiges of discipline upon the prudence and competence of management and by removing the incentives for the more sophisticated larger investors to consider the quality of an institution when they are deciding where to place their money?

Ms. Siebert. I would agree that the discipline is desirable if we were not in a period of what I call serious crisis. If I can give you primary examples. The New York bank, for instance, a couple of months ago, after one newspaper article appeared, had a $7 or $8 million jumbo that took a penalty to get their money out that day. That bank needed those funds. They had to go and borrow it at higher rates.

There is one large bank on next year's list for us where two trustees have recently resigned because in the State of New York they are personally liable and we have been unable to collateralize jumbo deposits. That bank has something like $100 million of uninsured deposits.

I have seen trustees leave the boards of these institutions. This is serious.

Mr. McCollum. Your concern is with the funds flowing out of the institutions in this time of crisis, and you are concerned that these large depositors would for the very reasons I stated likely take them out because of the quality of the institution?

Ms. Siebert. Yes; I also saw that we are also seeing Keogh accounts and IRA's leaving the institutions because it doesn't take too much to get some of these accounts over $100,000 for a bank that worked like heck with these people for years and when the account goes past the insurable line, they just pull it out.

Mr. McCollum. You are suggesting if we do this it would be a temporary measure, presumably for the duration of this particular crisis?

Ms. Siebert. Yes, I do.

Mr. McCollum. I have no further questions. I yield back.

Mr. St Germain. Mr. Schumer?

Mr. Schumer. Thank you, Mr. Chairman.

I will have many questions, but in the interest of time I will ask just one quick question.

Last week Under Secretary Roger Mehle came before this subcommittee. He stated that cash flow is far more important than net worth in determining bank soundness.

In New York State, however, as you know, we have a requirement that the superintendent close a bank down when its net worth is zero. Would you comment on his particular comment there?

Ms. Siebert. I have argued with Roger quite strongly over a long period of time. In my opinion, a bank that reaches zero, below zero, isn't solvent. The fact that it is able to meet the daily outflows,

which is his criteria for solvency, does not qualify as solvency under any standard that we know or that I can accept. The trustees are personally liable. It could be that they could also go to jail if that is the case.

Roger is presenting a very fine, interesting theoretical discussion, if you were writing a college paper, but not when you are dealing with people's life savings. I must respectfully disagree with him.

Mr. SCHUMER. Thank you. I yield back.

Mr. ST GERMAIN. I would like to hear Mr. Tiernan, Mr. Horn, and Mr. Malarkey respond to your question.

Mr. TIERNAN. Well, frankly, Mr. Chairman, we are of the opinion that there is some merit to Mr. Mehle's position that the true measure of viability is not simply net worth but should include some measure of liquidity, cash flow, if you will.

As you know, in the corporate law there are a number of different criteria by which one can judge insolvency. To say simply a net worth computation in the thrift industry is solvency or insolvency is to me a rather myopic position to take.

If you were to liquidate any institution today—this is to say any savings and loan institution today—it would be insolvent; there would be nothing there to pay stockholders or members. To say to me that an accounting technique that permits the carrying of assets at their book value constitutes solvency and certain extraordinary corporate actions that trigger adjustment of the assets to market can cause insolvency seems specious to me.

Mr. MALARKEY. I am inclined to agree with Ms. Siebert. As a matter of fact, the Delaware law says I agree with her. That is my job. I also agree that that cash flow is only one part of it. If you don't have the net worth, in Delaware, at least, you are insolvent. I have got to close them.

Mr. HORN. I can't disagree with the remarks made by my colleagues Siebert and Malarkey. The only complicating factor, Congressman, that I would throw into that, to carry that to its extreme, would require that you value the current portfolio at market, which would make pretty much every S. & L. in the country insolvent.

No one is suggesting that, but that would carry the position to the extreme.

I do agree with the practical problems involved when a statute requires personal liability on insolvency. Incidentally, we also have a New Jersey criminal liability for accepting the deposits in such circumstances.

Mr. ST GERMAIN. I think quite a few, if not the majority of the States have that same law.

Mr. SCHUMER. Mr. Chairman?

Mr. ST GERMAIN. Mr. Schumer.

Mr. SCHUMER. If I might interject, maybe we can make Mr. Mehle a trustee of a New Jersey or Delaware bank.

Mr. ST GERMAIN. You are precious.

Ms. SIEBERT. Can I add one thing to that? Mr. Mehle probably could be correct if 8.5 mortgages would some day be worth $1.10 on a dollar, which I think is very unlikely. Then you could say they could recoup this net worth out of the later increase in assets, but it highly unlikely.

Mr. St Germain. You all referred to the requirement that 50 percent of the funds be invested in housing. I think two of you said that you would go 60 percent and one of you said, I think Mr. Tiernan said, there shouldn't be any such requirement.

We have had other testimony as well on this point. However, it seems to focus more not on the requirement, because in essence S. & L.'s, if they want to take advantage of the tax benefits, have been required to invest 82 percent in direct residential mortgages.

It seems to me that the real hangup is the rate, how you pay the rate on these new mortgages, whether it be to the margin or whether to the average costs.

Do you oppose it entirely, Mr. Tiernan, not you as an individual, but does your organization oppose it because of the rate or just plain outright opposition?

Mr. Tiernan. Mr. Chairman, it is somewhat a function of the rate; that is, that a mortgage rate of 1 percent above the cost of funds would compound the problems that the institutions are facing today.

But I think it is also a question of philosophy of the organization; that is, that at this juncture the industry does not need its hands tied again. It needs some flexibility to restructure itself.

When I say restructure, I don't mean necessarily we are moving into commercial banking but, as Ms. Siebert alluded to, to be full family financial centers. So, I don't think that the organization would be against it if it were a viable form of lending, but as it is structured now, they feel that this would compound the industry's problems and have a chilling effect on many institutions coming forward to try to avail themselves of the program.

Mr. St Germain. But you know, your organization should understand that the motivation on one part is to assist the thrifts and the thrift industry. It is also to assist the homebuilding industry, the 3 million people out of work in that industry.

It is also designed to assist the millions of people there who right now are unable to buy a home. On the one hand, there are those who say, well, don't worry. In fact, we have another witness who will follow this panel that seems to think that thrifts will just stay in homeowner's lending automatically.

Now, there are those who question that. One of the reasons that powers legislation is installed for the thrifts is there is strong opposition on behalf of many who have a great fear that thrifts will get out of the homeowner's lending.

So, the reason for this provision is to indicate and demonstrate the legislation is just not designed solely for the thrifts, but to cover a broader spectrum of the people of this Nation and industries of this Nation who are suffering.

Mr. Tiernan. I think that is a point well taken. Perhaps we are remiss in that our perspective was a little myopic in that we thought this bill should be a little more limited in its focus to try to assist the thrift industry.We thought some other bills, that as we understand it are pending or soon to be introduced, would address those areas that will reinvigorate the housing industry and lead us out of this present recession.

Mr. St Germain. The problem of many of those is the price tag. We are trying to do this at no cost.

Mr. TIERNAN. We would be more than willing to reconsider our position and consider amending our testimony in light of your comments.

Mr. ST GERMAIN. Thank you.

Mr. Malarkey?

Mr. MALARKEY. Mr. Chairman, as you know, we suggested a 60 percent rather than 50 percent. We understand the dual purpose of the bill. But also a part of keeping this at no cost is that the institutions who get assistance become viable institutions.

This is certainly going to work against that, in my opinion.

Mr. ST GERMAIN. So we would appreciate even more input from you on how you think it should be structured.

Mr. MALARKEY. Thank you. Fine.

Mr. ST GERMAIN. Mr. Horn?

Mr. HORN. I am looking at the title of the subcommittee, Housing and Community Development. I can understand the concern of this committee with increasing the flow of funds into the home mortgage market. I strongly support the 50-percent requirement, and if it becomes 60 percent, I would support that as well, or even 70 percent.

That, of course, is consistent with my earlier statement that I am opposed to giving commercial lending powers to S. & L.'s or thrift institutions. I do, however, strongly recommend that you do take a look at whether or not there should be any rate regulation whatsoever on the funds.

I think you have done your job by insuring that new deposits go out into home mortgages, but I think that rate regulation would perhaps be counterproductive and perhaps even compound the problem some years down the road.

Mr. ST GERMAIN. Thank you. Anyone else have any further questions of this panel? If not, we express our appreciation to you gentlemen, to Ms. Siebert. I hope you get a plane in time to get where you are going.

Mr. Gonzalez, our chairman.

Chairman GONZALEZ. Thank you very much, Mr. Chairman. I have really a question, I guess, that would be more properly directed to Ms. Siebert.

In your testimony you clearly state that the State of New York has reached its outer limits of resources, and that there is no question that Federal level intervention is not only necessary but indicated it would be proper.

If you are familiar with yesterday's New York Times article, reporting I guess President Reagan's address to the realtors, the reality we are facing here is that this, I am sure, would be a bill that the President included in his statement to the effect that he would never accept bailouts, billion dollar bailouts.

Is it your opinion that this bill falls in that category? You know, what do we do unless we have some kind of a viable bipartisan recognition of this responsibility?

Ms. SIEBERT. I don't like to use the word bailout, but I guess I am forced to use the word assistance or help. There are two possibilities when you look at the problem of the thrifts. One is liquidation.

The mergers that have gone on have been done in a small fraction of the cost of liquidation. Many of these institutions, in the

case of the New York bank for savings, we saw very good estimat that it would cost possibly $1 billion to $1.2 billion if they were t liquidate this institution. That is money.

The assisted merger was done for a little less than $500 millio and could come through cheaper if interest rates come down. S we know when an institution has to, when the problems are so ser ous they have to be addressed, we now have one of two choices.

The commercial banks are inviting bids on three or four of ou institutions that we have now merged out. Their bids were all co siderably higher. They required more money than those that th thrifts were able to do.

Part of that was for two reasons. When you merge thrift wit thrift, especially in the same city, you cut down expenses. If yo consolidate branches, in the case of Greenwich. Metropolitan, I b lieve that they have fired, and it was painful, everyone over branch manager and the personnel manager. They did not need a of these extra people in the combined operation. Painful, yes. R quired, also yes.

I saw those people come to me that were fired. I do not thin that we can expect the Federal Government to walk down th street and put cash or help these institutions unless everybody se what we can do to help the situation.

So, if the word is bailout, it is bailout, but look what the altern tives are. The commercial banks were bidding for requiring muc more money because they are commercial banks, because they d have public stockholders, they must get a return on investment. S they will need more assistance from the FDIC or FDSLIC.

I said before if I saw a bid considerably cheaper for the FDIC. am going to sit down and talk commercial banking taking over th thrifts. I told that to one of the banks that was bidding: If yo happen to be the best bidder, if you will make a commitment th you will put that money in home mortgages. Their bids cam through requiring much more money. Somebody has to pick up th cost.

Chairman Gonzalez. Thank you.

Mr. Malarkey. I think you might be interested, Mr. Gonzale The cost of this plan is zero, if it is a success. It only becomes costl at such time as institutions fail. I don't know if that would com under the term bailout.

On March 23—I think Ms. Siebert referred to it—Wharton Eco ometric Forecasting Associates put out a report and analyzed th cost of the various plans and I think the assisted mergers.

The costs were: For 1982–84 income maintenance, $27.4 billio income certificates, $45.4 billion; mortgage warehousing, $39 bi lion; and the net worth guarantee they listed, zero.

It only becomes a factor if the assisted institution fails. So, I a not sure it would be termed a bailout.

Chairman Gonzalez. Very good point. Thank you very much. deeply appreciate your time.

Mr. St Germain. Mr. Wylie?

Mr. Wylie. Mr. Chairman, I would just like to say that I a truly sorry that I couldn't be here a little earlier to hear this exce lent panel. I know the testimony has been fruitful and I will ine the record.

I am especially delighted to see Ms. Siebert again. I don't want to delay the proceedings unnecessarily, so I will defer any questions.

Mr. St Germain. Thank you.

Once again, our gratitude to each of you. We will be in further consultation with you.

Chairman Gonzalez. We welcome William H. Kennedy, Jr., representing American Bankers Association; Mr. S. Allen Harris III, vice president of the Capital Bank Trust Co., Baton Rouge, La., representing the Independent Bankers Association of America, and Mr. Andrew S. Carron, research associate, economic studies program, The Brookings Institution.

Thank you very much, gentlemen. I have just been reminded, I was aware a while ago that our distinguished colleague from Arkansas is here. We thought that we would give him this opportunity to introduce Mr. Kennedy.

We thought we would start with Mr. Kennedy this afternoon, but I wanted to thank you each for having donated so much of your time and being so patient with us this day.

Mr. Bethune.

Mr. Bethune. Thank you, Mr. Chairman. The committee will soon realize that Mr. Kennedy, the president-elect of the American Bankers Association, is one of the more capable and sincere people who will testify before this subcommittee.

I could regale the committee at length with his contributions within the State of Arkansas. We are very proud that he is President-elect of the American Bankers Association and I am doubly proud because, as a member of the Banking Committee, I will have a chance to work even more closely with him.

So without spending any more valuable time because he and others have been waiting here since, I think, around 2 p.m. to bring their message, Mr. Chairman, I will yield back at this point.

Chairman Gonzalez. Thank you very much.

Mr. Kennedy, you may proceed as you see fit.

STATEMENT OF WILLIAM H. KENNEDY, JR., CHAIRMAN OF THE BOARD, NATIONAL BANK OF COMMERCE, PINE BLUFF, ARK., PRESIDENT-ELECT OF THE AMERICAN BANKERS ASSOCIATION

Mr. Kennedy. Thank you, Mr. Chairman, and thank you, Congressman Ed Bethune.

We appreciate the opportunity to testify on H.R. 5568, the Home Mortgage Capital Stability Act.

We recognize the problems of the thrift industry. These problems are illustrated by almost any figures on the thrift industry that one consults. For example, the net worth of the savings and loans fell by $864 million in January 1982.

Since January 1981, industry net worth has declined by $5.53 billion, a 17.1-percent decrease. Deposits of the thrift institutions declined by $331 million in January 1982, then picked up in February of 1982 by about $700 million.

These figures are aggregate figures and obscure the conditions of individual institutions that are doing well and have no need for aid ιy kind. Other thrift institutions are in trouble and do have a for aid. If there is to be some type of legislative assistance to

the thrifts, it should be targeted only to those institutions that truly need the aid.

This will help to keep the cost of the aid program down in this period of spending restraint by the Government. Also, any aid should be targeted only to those institutions that deserve it. Some of the problems of the institutions are caused by bad management which should not be subsidized.

Industry figures for the banks show that they have not been hit as hard as thrifts. Income as a percent of assets has remained fairly stable over time with a small decline for 1981, but bank profitability relative to other industries has declined.

Again, the aggregate figures obscure the position of individual commercial banks. Many of the members of our association are community banks with large portfolios of mortgages. These members are experiencing essentially the same problems as the thrift institutions and should be eligible for the same aid as the thrift institutions.

In addition, banks in agricultural areas have been hard hit by the effect of high interest rates on the income of farmers.

Commercial banks are not immune to the problems experienced by thrift institutions and the costs involved in aiding the troubled institutions. Banks have been subject to increased cost of funds and runoffs of deposits as depositors have become aware of alternative investments offering higher rates of return than can be paid on many accounts at banks.

As members of the FDIC, commercial banks have borne part of the cost of aiding troubled institutions. Members of the FDIC have experienced a net increase in assessment fees paid to the FDIC because of the aid required by mutual savings banks.

This net increase has come in the form of a significantly reduced rebate on the premium this year, and there is no expectation of a rebate on premium next year or for some years thereafter.

Commercial banks are disadvantaged as well by the paralysis of the legislative process and DIDC decisions regarding the deregulation of depository institutions.

Our association commends the House Banking Committee on its efforts to date to address the short-run problems of the depository institutions. The chairman and other members have been in the forefront of much legislation aimed at easing the present difficulties.

Our association supported the regulator's bill, H.R. 4603, with some amendments, that was passed by the House last year. The bipartisan leadership of the committee assured passage of the resolution affirming that deposits at Federally-insured banks and savings institutions are backed by the full faith and credit of the United States.

Although we did not feel that this was necessary, we commend the responsiveness of the committee to the Federal Home Loan Bank Board, which did feel it was needed.

Aid measures for either depository institutions or housing must be viewed in the context of budget deficits and the cost of other aid plans under consideration. A lowering of the interest rates is the only thing that will solve the problems of the thrifts and the other sectors of the economy such as housing and agriculture.

Any policy which frustrates the decline in interest rates is misdirected. Because the budget deficit is an important influence on interest rates, the cost of various plans must be a primary consideration.

There are numerous aid plans being considered, each having a potential effect on the budget deficit. It is difficult to comment on any single aid plan because there is no guarantee that it will be the only plan enacted.

Most likely, other aid plans will also be enacted which together could have an unhealthy effect on the budget deficit and the economy. We feel that the effect on the budget of any aid plan being considered is of paramount importance.

Although lower interest rates will ease the short-run problems of the thrift institutions, the thrifts will be subject to the same earnings problems if interest rates increase again unless they accept the reality of the marketplace.

The marketplace for consumer deposits no longer belongs exclusively to the depository institutions. High interest rates and regulation Q restrictions on rates that can be paid on time and savings accounts have seen to that.

Money market funds, uninsured but able to pay market rates on deposits, have attracted billions of dollars from depository institutions. Depository institutions will be at a disadvantage as long as they are prevented from competing effectively in the marketplace.

Repeated periods of losses for large numbers of depository institutions can be expected until legislation is enacted or regulations are changed to allow the depository institutions to compete with money market funds in offering market interest rates on deposits.

Any legislation that prevents the adjustment should be called into question, and any expenditure of taxpayers' money which insulates the institutions from the realities of the marketplace is costly to the banking and thrift industry and an unwise use of public funds.

Our association feels that the long-term interest of all depository institutions can be best served by expansion of competitive powers for all institutions. The consensus statement outlining our association's position is in the back of our report submitted to you.

It outlines the willingness of our Association, given certain conditions, to support the extension to thrift institutions of various bank-like powers that would enable them to compete in the future.

We would like to emphasize the fact that there is no need for any aid program for depositors. There are enough resources available to protect depositors in the event the institution holding their funds experience difficulties.

The FIDC, FSLIC, and companion State insurance corporations have sufficient funds to deal with the problem. In addition, the resolution backing insured deposits with the full faith and credit of the United States adds additional protection.

Legislation which eases the problems of individual depository institutions and their management should not be used to bail out bad managers, but rather to aid good managers in their adjustment to changed market conditions. This adjustment can best be accomplished by allowing the thrifts more diversity in their portfolios, and any aid should be considered as a bridge to that point.

Some legislation is being considered or has been enacted which will ease the problems of the thrift institutions. To the extent that this legislation gives expanded asset powers to thrifts, concern has been expressed about a decrease in the funds available to the housing industry.

These fears are unfounded. The housing industry is no longer so closely linked to the behavior of the thrift industry. It is currently held hostage to inflation and high interest rates, but has become much more integrated into the capital market.

Although the thrift institutions continue to play a large role in the financing of housing, other investors have and will increase their role in the provision of housing finance.

Savings and loans and mutual savings banks together hold less than half of the residential mortgages outstanding. Commercial banks hold about 16 percent and mortgage pools and trusts hold about 12 percent. The proportion of housing credit supplied by commercial banks has been trending upwards since the mid-1960's. In addition, commercial banks have supplied funds for various activities needed to support housing in addition to home mortgages.

Mr. Chairman, we cannot tell you whether any aid program should be passed. Consideration must be given to the totality of all aid programs finally enacted and their effect on the budget. The evaluation of any single aid program ignores the budgetary effect of other aid programs. We do feel, however, that H.R. 5568 in its present form should not be enacted.

To evaluate in a uniform fashion the many proposals being considered, a set of criteria was developed and accepted by the banking leadership conference of the association. These criteria are contained in attachment 4.

The first and second criteria deal with the financing of the aid for troubled depository institutions. The first states that the aid should be explicit and the cost included in the budget such that Congress must vote on the amount aid in H.R. 5568.

The second criterion states that the aid should be limited to a certain time period and not automatically extended. Although H.R. 5568 proposes that institutions may use the assistance for no more than 2 years, there is no cutoff date for aid to the institutions. The bill as written meets the first criterion, but not the second.

The third and fourth criteria deal with who should receive the aid and the conditions that should be put on the institutions which receive the aid. The third specifies that the assistance should be made available on the same terms to all federally-insured depository institutions which are experiencing difficulty.

The legislation as written does satisfy this, but is biased toward savings and loan institutions. Because both savings banks and commercial banks are regulated more strictly than savings and loans, the 2-percent capital ratio would rule out participation by most of these institutions.

Given the criteria in the bill, of the 17 banks that failed or were merged by the FDIC in 1980 and 1981, none would have qualified for aid.

The fourth calls for disincentives to using the aid. The bill contains some disincentives, but these are insufficient to prevent misuse of the aid by unqualified institutions.

The fifth criterion states that the type of aid should be determined by whichever has the minimum cost to the agency extending the aid. Has this aid been determined to be the least cost method of aiding the institutions? There may be other means that could accomplish the same goal at lower cost and these alternatives, we think, should be examined.

In addition to the points raised above, our association has other comments regarding H.R. 5568. It has been indicated that the bill may be amended to use a government guarantee rather than a cash loan. As stated above, we would prefer the use of a government guarantee rather than a loan.

Although the intent of the proposed bill is to aid the short-run problems of the specialized thrift institutions, the means of giving this aid are questionable. The attempt to combine aid to the depository institutions and the housing industry, while well intentioned, is unworkable as stipulated.

Requiring that 50 percent of an institution's net new deposits be lent to first-time home buyers at 1 percent over the average cost of funds for the institution increases the long-run adjustment problems of thrift institutions.

They will again be burdened with mortgages that are below the market rate of interest. The long-run position of the thrifts would be improved by having them expand their portfolio of assets to give a better match to the liabilities that are held.

The lending requirement will cause the institutions to be worse off than before. The new lending will most likely be at a rate below the cost of the new deposits that will support the lending. The estimated cost of funds over the last six months of 1981 for savings and loans was 11.50 percent.

New funds will be attracted by those deposits that pay close to the market rate. As an example, 6-month money market certificates paid an average of 14.09 percent over the last 6 months of 1981.

Under the bill's requirement, the loan would have to be made at 12.50 percent and would be supported by funds costing 14.09 percent. This would result in a loss to the institution of 1.5 percent per year. Thus the institution is worse off for making the loan.

Our association does support the goals of this legislation. However, we feel the goals can only be accomplished through a period of low interest rates. To the extent that the aid package adds to the deficit or frustrates the decline in interest rates, it does more harm than good.

In addition, any legislation that attempts to shield the specialized thrift institutions from the realities of the marketplace will not work and will ultimately be very costly to banking and the specialized thrift institutions.

[Mr. Kennedy's prepared statement, on behalf of the American Bankers Association, follows:]

STATEMENT

OF

WILLIAM H. KENNEDY, JR.

on behalf of

THE AMERICAN BANKERS ASSOCIATION

on H.R. 5568

before the

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

March 31, 1982

Mr. Chairman, and members of the Committee, I am William H. Kennedy, Jr. President-elect of the American Bankers Association (ABA) and Chairman of the Board of the National Bank of Commerce, Pine Bluff, Arkansas. Our Association's membership includes over 90 percent of the more than 14,500 full service banks in the United States. While our members range in size from the very smallest to the very largest banks, approximately 90 percent of them have assets of less than $100 million.

We appreciate the opportunity to testify on H.R.5568, the "Home Mortgage Capital Stability Act." The goals of this legislation are to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensure the availability of home mortgage loans at a reasonable rates. This is to be accomplished by giving aid to troubled institutions to prevent additional decreases in net worth. In return for this aid, the institutions must make mortgages at below market interest rates to first time home buyers.

We recognize the problems of the thrift industry. These problems are illustrated by almost any figures on the thrift industry that one consults. For example, the net worth of the savings and loans fell by $864 million in January 1982. During 1981, industry net worth has declined by $5.53 billion, a 17.1% decrease. Deposits of the thrift institutions declined by $331 million in January 1982. However, in February, 1982 the deposits at savings and loans increased by $700 million. [1]

The figures given above are aggregate figures and obscure the conditions of individual institutions that are doing well and have no need

[1] Wall Street Journal, February 26, 1982, March 26, 1982

for aid of any kind. Other thrift institutions are in trouble and do have a need for aid. If there is to be some type of legislative assistance to the thrifts, it should be targeted only to those institutions that truly need the aid. This will help to keep the cost of the aid program down in this period of spending restraint by the government. Also, any aid should be targeted only to those institutions that deserve it. Some of the problems of the institutions are caused by bad management which should not be subsidized.

Industry figures for the banks show that they have not been hit as hard as thrifts. Income as a percent of assets has remained fairly stable over time with a small decline for 1981, but bank profitability relative to other industries has declined. (See Attachment 1). Commercial banks do not profit from high interest rates, but also their earnings are not devastated by high rates either. This stability results from the diversification of commercial bank portfolios.

Again, the aggregate figures obscure the position of individual commercial banks. Many of the members of our Association are community banks with large portfolios of mortgages. These members are experiencing essentially the same problems as the thrift institutions and should be eligible for the same aid as the thrift institutions. In addition banks in agricultural areas have been hard hit by the effect of high interest rates on income of farmers.

Commercial banks are not immune to the problems experienced by thrift institutions and the costs involved in aiding the troubled institutions. Banks have been subject to the increased cost of funds and runoffs of deposits as depositors have become aware of alternative investments offering higher rates of return than can be paid on many accounts at banks.

As members of the FDIC commercial banks have borne part of the cost of aiding troubled institutions. Members of the FDIC have experienced a net increase in assessment fees paid to the FDIC because of the aid required by mutual savings banks. This net increase has come in the form of a significantly reduced rebate on the premium this year and there is no expectation of a rebate on premium next year or for some years thereafter. Commercial banks are disadvantaged as well by the paralysis of the legislative process and DIDC decisions regarding the deregulation of depository institutions.

The Association commends the House Banking Committee on its efforts to date to address the short run problems of the depository institutions. The Chairman and other members have been in the forefront of much legislation aimed at easing the present difficulties. The Association supported the regulator's bill, HR4603, with some amendments, that was passed by the House last year. The bipartisan leaderhip of the Committee assured passage of the resolution affirming that deposits at federally insured banks and savings institutions are backed by the full faith and credit of the United States. Although we did not feel that this was necessary, we commend the responsiveness of the Committee to the Federal Home Loan Bank Board, which did feel it was needed.

I. Long Run Considerations

Aid measures for either depository institutions or housing, must be viewed in the context of budget deficits and the cost of other aid plans under consideration. A lowering of the interest rates is the only thing that will solve the problems of the thrifts and the other sectors of the

economy such as housing and agriculture. Any policy which frustrates the decline in interest rates is misdirected. Because the budget deficit is an important influence on interest rates, the cost of various plans must be a primary consideration.

There are numerous aid plans being considered, each having a potential effect on the budget deficit. It is difficult to comment on any single aid plan because there is no guarantee that it will be the only plan enacted. Most likely other aid plans will also be enacted which together could have an unhealthy effect on the budget deficit and the economy. We feel that the effect on the budget of any aid plan being considered is of paramount importance.

Although lower interest rates will ease the short run problems of the thrift institutions, the thrifts will be subject to the same earnings problems if interest rates increase again unless they accept the reality of the market place. The market place for consumer deposits no longer belongs exclusively to the depository institutions. High interest rates and Regulation-Q restrictions on rates that can be paid on time and savings accounts have seen to that. Money market funds, unregulated as to rate and uninsured but able to pay market rates on deposits have attracted billions of dollars from depository institutions. Depository institutions will be at a disadvantage as long as they are prevented from competing effectively in the market place. Repeated periods of losses for large numbers of depository institutions, can be expected until legislation is enacted or regulations are changed to allow the depository institutions to compete with money market funds in offering market interest rates on deposits. Any legislation that prevents the adjustment should be called into question, and any expenditure of taxpayers money which insulates the institutions

from the realities of the market place is costly to the banking and thrift industry and an unwise use of public funds.

Our Association feels that the long term interest of all depository institutions can be best served by expansion of competitive powers for all institutions. The consensus statement outlining our Association's position is in Attachment 2. It outlines the willingness of our Association, given certain conditions, to support the extension to thrift institutions of various bank like powers that would enable them to compete in the future.

Since the largest competition faced by depository institutions is from money market funds, depository institutions must have some way of gaining back the funds that have been drawn away by this competitor. Our Association has been urging for some time that the Depository Institutions Deregulation Committee act to increase the competitiveness of the depository institutions. We have been proposing three kinds of actions: (1) create a short term deposit instrument in the form of special NOW account on which there would be no interest rate ceiling on the entire balance in the account as long as the balance was above $5,000; the NOW account ceiling would be imposed whenever the balance fell below $5,000 (2) establish a firm schedule for the deregulation of interest rate ceilings on all categories of time and savings deposits; and (3) lower the minimum denomination of certificates with no ceiling from $100,000 to $25,000. The first action will let depository institutions compete much more effectively for the relatively large amounts of small consumer deposits that are currently being lost to money market funds. The second action will provide depository institutions with the time to adjust to ceilingless deposit accounts. By beginning with longer term deposits, it will also permit

managers to better control asset and liability risk and attract longer term deposits most appropriate for longer term lending. The third action will let them compete much more effectively for some relatively large consumer deposits and, more importantly, the large amounts of deposits from small businesses, local governments, and non-profit institutions that are currently being lost to money market funds.

At its March 22 meeting, DIDC did agree to a firm schedule for deregulation of instruments, but did not pass the other two items. It created a new instrument that is not competitive with money market funds and will only cause a shifting of funds within and among depository institutions. An instrument that will allow depository institutions to compete with the money market funds is needed if depository institutions are to maintain their ability to serve their customers' needs.

II. Aid Proposals

We would like to emphasize the fact that there is no need for any aid program for depositors. There are enough resources available to protect depositors in the event the institution holding their funds experience difficulties. The FDIC, FSLIC and companion state insurance corporations have sufficient funds to deal with the problem. In addition, the resolution backing insured deposits with the full faith and credit of the United States adds additional protection.

Legislation which eases the problems of individual depository institutions and their management should not be used to bail out bad managers, but rather to aid good managers in their adjustment to changed market conditions. This adjustment can best be accomplished by allowing the thrifts more diversity in their portfolios, and any aid should be considered as a bridge to that point.

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Some legislation is being considered or has been enacted which will ease the problems of the thrift institutions. To the extent that this legislation gives expanded asset powers to thrifts, concern has been expressed about a decrease in the funds available to the housing industry. These fears are unfounded. The housing industry is no longer so closely linked to the behavior of the thrift industry, (it is currently held hostage to inflation and high interest rates) but rather has become much more integrated into the capital market. Although the thrift institutions continue to play a large role in the financing of housing, other investors have and will increase their role in the provision of housing finance. Savings and loans and mutual savings banks together hold less than half of the residential mortgages outstanding. Commercial banks hold about 16% and mortgage pools and trusts hold about 12%. The proportion of housing credit supplied by commercial banks has been trending upwards since the mid-1960's. In addition, commercial banks have supplied funds for various activities needed to support housing in addition to home mortgages. (See Attachment 3 "Banking's Contribution to Housing.")

Mortgage pools and trusts have increased their holdings dramatically since the early 1970's. The growth of mortgage pools and trusts as a supplier of mortgage credit in the last few years illustrates that other lenders are furnishing credit at an increasing pace. With the secondary market for mortgages, alternative sources of credit are developing which will continue to supply the housing needs in the future. The President's Commission on Housing has recognized this fact and recommended specific changes that would aid in increasing diversification of the supply of housing finance.

We feel that aid to institutions or managers rather than depositors is

not needed. If, however, it is decided to give some aid, certain aspects need to be considered. The institutions that need the aid because of market conditions should be eligible for aid. The aid should be made with incentives for portfolio adjustment of the institution to the long run realities of the market place. In addition, there should be some disincentives such that the use of this aid is not considered lightly. Institutions that have need of aid because of poor management should not be eligible. Many bankers perceive that some troubled savings and loans are not making the management changes needed to cope with the changing reality. Much of the evidence is anecdotal but the feeling is widespread among bankers that this is true. If this is the case, these institutions should not be eligible for the aid. The best way to assure that aid is going to those instituitons which deserve it,is to give the regulators discretion in determining the institutions which will be eligible for aid. Without this discretion, undeserving managements will receive aid, resulting in continued problems for the thrift industry because of subsidization of bad managers and increased costs to the taxpayers.

Once the eligible institutions are determined and the aid is given, those institutions must be able to use the aid in the most efficient manner. Any aid that is given is a loan or potential loan of tax payers money. Since banks are money lenders, they are familiar with the problems involved and the conditions that one puts on loans. When a bank lends money it wants to make sure that it will be paid back. To accomplish this, once the borrower has been approved, it must be able to use the funds in a manner thay enhances its ability to repay the loan. If the bank tries to dictate policy on the usage of the funds, it may prevent the firm or individual from using them in the most profitable manner and therefore

cause it to go under. Thus the loan is not paid back and the bank loses. Similarly, if the borrowing institutions that are eligible for this aid are too heavily controlled,they will not become profitable and the taxpayer will lose. In short, put rigorous requirements on determining which institutions are eligible for aid, but once the aid is given, allow the institutions to operate in the most efficient manner.

Finally, any aid given should be given in the form of guarantees or some type of capital certificates rather than as cash loans. This will decrease the upfront cost of the aid and minimize its impact on the budget deficit. In addition, if the aid is successful in its purpose of preventing the failure of the institutions, then there should be no reason to exercise the provisons of the guarantee. However, additional powers and incentives are still needed to bring about the desired long run adjustments.

III. HR 5568

Mr. Chairman, we cannot tell you whether any aid program should be passed. Consideration must be given to the totality of all aid programs finally enacted and their effect on the budget. The evaluation of any single aid program ignores the budgetary effect of other aid programs. We do feel however, that H.R. 5568 in its present form should not be enacted.

To evaluate in a uniform fashion the many proposals being considered, a set of criteria was developed and accepted by the Banking Leadersip Conference of the Associaiton. These criteria are contained in Attachment 4.

The first and second criteria deal with the financing of the aid for

troubled depository institutions. The first states that the aid should be explicit and the cost included in the budget such that Congress must vote on the amount aid in HR 5568. The second criterion states that the aid should be limited to a certain time period and not automatically extended. Although H.R.5568 proposes that institutions may use the assistance for no more than two years, there is no cutoff date for aid to the institutions. The bill as written meets the first criterion but not the second.

The third and fourth criteria deal with who should receive the aid and the conditions that should be put on the institutions which receive the aid. The third specifies that the assistance should be made available on the same terms to all federally insured depository institutions which are experiencing difficulty. The legislation as written does satisfy this, but is biased toward savings and loan institutions. Because both savings banks and commercial banks are regulated more strictly than savings and loans, the two percent capital ratio would rule out participation by most of these institutions. Given the criteria in the bill, of the 17 banks that failed or were merged by the FDIC in 1980 and 1981, none would have qualified for aid. (See Attachment 5). The fourth calls for disincentives to using the aid. The bill contains some disincentives, but these insufficient to prevent misuse of the aid by unqualified institutions.

The fifth criterion states that the type of aid should be determined by whichever has the minimum cost to the agency extending the aid. Has this aid been determined to be the least cost method of aiding the institutions? There may be other means that could accomplish the same goal at lower cost and these alternatives should be examined.

In addition to the points raised above, the Association has other comments regarding H.R. 5568. It has been indicated that the bill may be

amended to use a government guarantee rather than a cash loan. As stated above, we would prefer the use of a government guarantee rather than a loan.

Although the intent of the proposed bill is to aid the short-run problems of the specialized thrift institutions, the means of giving this aid are questionable. The attempt to combine aid to the depository institutions and the housing industry, while well intentioned is unworkable as stipulated.

Requiring that 50% of an institution's net new deposits be lent to first-time home buyers at 1% over the average cost of funds for the increses the long-run adjustment problems of thrift institutions. They will again be burdened with mortgages that are below the market rate of interest. The long run position of the thrifts would be improved by having them expand their portfolio of assets to give a better match to the liabilities that are held.

The lending requirement will cause the institutions to be worse off than before. The new lending will most likely be at a rate below the cost of the new deposits that will support the lending. The estimated cost of funds over the last 6 months of 1981 for savings and loans was 11.50%. New funds will be attracted by those deposits that pay close to the market rate. As an example, six month money market certificates paid an average of 14.09% over the last six months of 1981. Under the bill's requirement, the loan would have to be made at 12.50 and would be supported by funds costing 14.09%. This would result in a loss to the institution of 1.5% per year. Thus the institution is worse off for making the loan.

IV. Conclusion

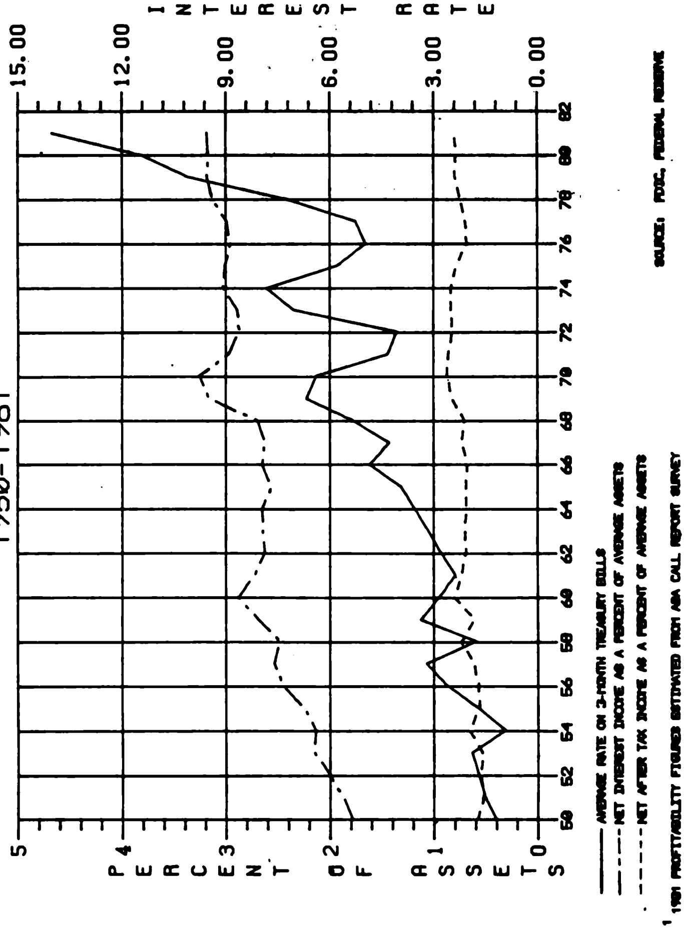
Our Association does support the goals of this legislation. However,

we feel the goals can only be accomplished through a period of low interest rates. To the extent that the aid package exacerbates the deficit or frustrates the decline in interest rates it does more harm than good. In addition, any legislation that attempts to shield the specialized thrift institutions from the realities of the market place will not work and will ultimately be very costly to banking and the specialized thrift industries.

ATTACHMENT 1

Chart 1

INTEREST RATES AND COMMERCIAL BANK PROFITABILITY[1] 1950-1981



[1] 1981 PROFITABILITY FIGURES ESTIMATED FROM ABA CALL REPORT SURVEY

SOURCE: FDIC, FEDERAL RESERVE

Table 1

--Net Income as a Percent of Average Assets--
Rank of Bank Profitability Compared
to 30 Other Industries 1/

Year	Rank
1969	21
1970	23
1971	17
1972	8
1973	8
1974	9
1975	9
1976	17
1977	23
1978	23
1979	23
1980 2/	40

1/ From Survey of Industry conducted yearly by Forbes magazine.

2/ 49 industries surveyed.

Table 2

Income After Taxes

	Insured Commercial Banks	All Corporations	Bank income as a Percent of Corporat Income
	$ billion		(%)
1965	2.51	46.3	5.42
1966	2.68	49.4	5.43
1967	3.14	47.2	6.65
1968	3.42	49.4	6.92
1969	4.33	47.2	9.17
1970	4.84	41.3	11.72
1971	5.24	49.0	10.69
1972	5.65	58.9	9.59
1973	6.58	76.6	8.59
1974	7.09	85.1	8.33
1975	7.25	81.5	8.90
1976	7.84	102.5	7.65
1977	8.88	120.0	7.40
1978	10.76	140.3	7.67
1979	12.84	167.8	7.65
1980	14.01	163.2	8.58

Source: FDIC Annual Reports, Economic Report of the President, February 1982.

Table 3

Bank Profitability and Inflation

Year	Insured Commercial Return on Equity (Net Income as a Percent of Average Equity) a/	Inflation Rate b/	Estimate of Return on Equity After Adjusting for Inflation c/ High Estimate d/	Low Estimate
	%	%	%	%
1965	9.01	1.9	7.6	7.4
1966	9.20	3.4	6.5	5.9
1967	10.13	3.0	7.8	7.2
1968	10.27	4.7	6.4	5.6
1969	12.01	6.1	6.8	6.0
1970	12.40	5.5	7.8	7.0
1971	12.43	3.4	10.1	9.3
1972	12.29	3.4	9.3	8.3
1973	12.95	8.8	5.3	4.3
1974	12.59	12.2	1.7	0.8
1975	11.75	7.0	5.6	4.8
1976	11.48	4.8	7.8	6.6
1977	11.71	6.8	5.8	5.0
1978	12.90	9.0	4.9	4.1
1979	13.90	13.3	2.0	1.1
1980	13.68	12.2	2.8	1.9

a/ Average of equity capital at beginning of year and end of year.

b/ Percent increase in the Consumer Price Index, December to December.

c/ Both estimates of return on equity ignore gains or losses resulting from a maturity imbalance between assets and liabilities when interest rates change. Both estimates also treat changes in the equity account, other than dividends or profits, the same as net sale of stock.

Footnotes continued on next page.

d/ The high estimate of return on equity assumes that dividends are paid at the first of the year and any net sale of stock occurs at the end of the year. Thus, net return on equity is calculated as

$$\bar{R}_t = \frac{(E_t - S_t)\left(\dfrac{\frac{1}{CPI_t}}{CPI_{t-1}}\right)}{E_{t-1} - D_t} - 1$$

where

$\bar{R}_t$ = high estimate of net return on equity adjusted for inflation.

E_t = equity capital at end of period t.

S_t = net sale of stock in period t.

D_t = dividends paid during period t.

CPI_t = consumer price index during period t.

Since data for S was not available for all periods it was estimated by
$S_t = E_t - E_{t-1} + D_t - P_t$

where P_t = net income during year t.

e/ The low estimate of return on equity assumes that dividends are paid at the end of the year and any net sale of stock takes place at the beginning of the year. Thus,

$$\hat{R}_t = \frac{(E_t + D_t)\left(\dfrac{\frac{1}{CPI_t}}{CPI_{t-1}}\right)}{E_{t-1} + S_t} - 1$$

where

$\hat{R}_t$ = low estimate of return on equity adjusted for inflation.

Attachment 2

Perspective: Banking Leaders' Consensus

The American Bankers Association will seek in every possible forum and via every possible legislative and regulatory vehicle the expansion of bank powers which is necessary to make banking competitive in the 1980s. This includes a permanent federal usury override, a permanent override of state prohibitions of due-on-sale clauses, significant relief from banking's regulatory burden (FIRA, Truth in Lending, and CRA, for example) and all the banking powers enumerated in ABA's earlier response to S. 1720 and in ABA's banking agenda for change endorsed by the Banking Leadership Conference.

The Banking Leadership Conference reiterated its support for existing provisions of S. 1720 which override state prohibitions of due-on-sale clauses in mortgages; override state usury statutes; authorize bank underwriting of revenue bonds and offering of mutual funds; substantively reform the Truth in Lending Act; eliminate excessive restrictions in the Financial Institutions Regulatory Act; liberalize national bank lending and borrowing limits, real estate activities and the treatment of bankers' acceptances and of bank affiliates; and provide the regulatory agencies with additional powers they have requested to deal with troubled depository institutions.

Looking beyond these provisions, which currently are part of S. 1720, the Banking Leadership Conference concluded that modernization of banking laws to permit local banks to continue to serve the financial needs of their customers and communities must also include: authorization for banks to offer a full line of insurance brokerage services; removal of any restrictions on the offering of full securities brokerage services; permission to make equity investments in real estate (as all other financial entities are permitted to do); and authorization to engage in real estate brokerage, development and management activities.

Any acceptance by banking of any further bank-like powers for thrift institutions is dependent absolutely upon material progress toward deregulation in the March 22nd meeting of the DIDC. Such progress should include establishment of a dependable schedule for phasing out Reg Q and the differential and the creation of truly competitive, short-term deposit instruments.

Further, any acceptance by banking of any bank-like powers for thrifts is dependent upon Congressional support for banking's agenda for change. In any event, thrift institutions will have to make their own political case for expansion of their asset powers. To the extent that they are able to make that case convincingly, the following is a plan on which the members of the Banking Leadership Conference would be willing to seek wider agreement within the nationwide banking community:

o Provided that the statutory interest rate differential is repealed and DIDC directed to remove all existing differentials, all federal S&Ls would be permitted to originate, acquire, and hold up to 5% of their assets in commercial loans if such loans are made within the state where the S&L is located or within 75 miles of the S&L's home office, and to accept demand deposits which are tied to such commercial loans.

o At such time as Reg Q is phased out, federal S&Ls and federal mutual savings banks would be permitted to originate, acquire, and hold an additional 5% of their assets in commercial loans (for an aggregate of 10%).

o Any federal S&L or mutual savings bank wishing to originate, acquire and hold more than 10% of its assets in commercial loans or 20% in consumer loans would be required to seek a bank charter as either a national or state chartered institution. As a bank, the former thrift institution would then have to comply with applicable state branching laws, if any. In the event the branches were prohibited, the institution would be given two years to dispose of these branches. If branches are allowed, they could be retained. If holding company laws apply, the branches would have to be converted to holding company affiliates.

o In addition, all commercial banks should at their option be permitted membership in the Federal Home Loan Bank System similar to the status now enjoyed by some FDIC-insured mutual savings banks and life insurance companies. This provides the opportunity for banks active in mortgage finance to qualify for FHLBB advances and loans. Also, banks should have the option of converting their charters to federally insured savings and loans.

Regarding the special powers requested by the regulators to deal with troubled financial institutions, ABA renews its previous support for the regulators' bill, which generally is incorporated in S. 1720, with further amendments suggested by the regulators (a $1 billion threshold to trigger application of the powers to failing banks and continued regulation by the FDIC of mutual savings banks converting to federal charters).

Regarding action on expansion of depositories' powers, the determinant is whether the Congress, the DIDC and the thrift industry show by their actions a bona fide interest in working with banking for our agenda for change. A key measurement of this commitment will be the DIDC's March 22 decisions. If this commitment is evident, banking is prepared to reciprocate by considering a fiscally responsible program for dealing with the low-yielding mortgage situation of all depositories and by agreeing to the plan described above for thrift asset powers.

Attachment 3

BANKING'S INVESTMENT IN HOUSING FINANCE

The home mortgage market represents the largest private capital market in the U.S., with over $150 billion in home mortgages originated annually by all lenders. Only the debt requirements of the Federal government exceed the annual credit requirements for home mortgages.

In order to raise the enormous capital required for mortgage lending, a complex network of lenders, government agencies, and investors has been developed to deliver mortgage loans to the millions of families and individuals buying a home each year. The two largest sources of mortgage credit funds are savings and loan associations (of which there are about 4,600 institutions) and full service banks (of which there are about 14,500 institutions). Other lenders are the mutual savings banks (460 institutions); mortgage bankers; and life insurance companies.

In the past, thrift institutions have garnered most of the credit for financing residential housing. But direct mortgage credit is not the sole requirement for providing decent housing. Housing also depends on the existence of streets and sewers, utilities, construction companies and industry to produce housing materials; each of these elements is financed by banks.

I. Residential Mortgage Loans

Banks held $187.4 billion in residential mortgages at the end of the fourthquarter of 1981, ranking second only to the savings and loan industry in these loans. Moreover, full service banks originated $22.3 billion in residential mortgage loans during 1981, over 20% of the total. 1/

Residential Mortgage Loans Outstanding by Type of Lender
Fourth Quarter 1981
(Billions of Dollars)

Lender	One-to-Four Family	Pct. of Total	Multi-Family	Pct. of Total	Total	Pct.of Total
Savings and Loans	432.7	42.5	38.3	26.7	471.0	40.6
Full Service Banks	172.5	16.9	14.9	10.4	187.4	16.1
Mortgage Pools or Trusts	136.3	13.4	10.1	7.0	146.4	12.6
Mutual Savings Banks	65.4	6.4	17.4	12.1	82.8	7.1
Federal & Related Agenices	66.8	6.6	14.6	10.2	81.4	7.0
Life Insurance Companies	17.8	1.7	19.9	13.9	37.7	3.2
All Others	126.5	12.4	28.3	19.7	154.8	13.3
Total	1018.0	100.0%	143.5	100.0%	1161.5	100.0%

Source: Federal Reserve Bulletin, February, 1982

1/ HUD News No. 82-45, March 9, 1982

II. Secondary Mortgage Market

The secondary mortgage market has become an increasingly vital segment of the total residential financing system. Banks contribute significantly to the support of these secondary markets through ownership of their securities. As of the end of December 1981, banks held $14.2 billion in debt securities of the three sponsored secondary market agencies. Banks hold over 20% of the total outstanding debt issues of the largest of the agencies, the Federal National Mortgage Association.

In addition to these secondary mortgage market securities, banks also hold $14.4 billion in securities of the Federal Home Loan Banks. Thus banks hold a total of $28.6 billion in obligations of federal government agencies involved in housing.

Housing Related Securites Held by Banks
December 1981
(Billions of Dollars)

Secondary Mortgage Market	
Federal National Mortgage Association	13.1
Government National Mortgage Association	.5
Federal Home Loan Mortgage Corporation	.6
Subtotal	14.2
Other housing related Agencies	
Federal Home Loan Banks	14.4
Subtotal	14.4
Total	28.6

Source: Treasury Bulletin, February 1982, TSO 4 & 5

III. Mobile Home Loans

Banks are the major source of credit for purchasing mobile homes which have become the dominant factor in the low-cost housing market. Mobile homes accounted for 20.6% of the new single family dwellings sold in the U.S. in 1980 1/ and strong sales continue. Mobile homes are virtually the only kind of low-cost housing that is widely available to American families earning under $8,000 per year. As of December 31, 1981 banks had $10.3 billion in mobile home loans outstanding, 55.7% of the total. 2/

1/ Survey of Current Business, December, 1981

2/ Federal Reserve Bulletin, February, 1982

IV. Residential Construction Loans

Banks are a major supplier of funds for residential construction, an essential base of housing finance. At the end of the fourth quarter of 1981, banks held $18.5 billion in residential construction loans, over 47% of the total.

Holdings of Residential Construction Loans by Type of Lender
Fourth Quarter 1981
(Billions of Dollars)

Lender	One-to-Four Family	Multi-Family	Total
Full Service Banks	12.0	6.5	18.5
Savings & Loan Associations	11.5	2.2	13.7
Federal Credit Agencies	.0	2.6	2.6
Mortgage Companies	.9	.7	1.6
Mutual Savings Banks	.6	.7	1.3
All Others	*	1.3	1.3
TOTAL	25.0	14.0	39.0

*Less than .05

Source: HUD News No. 82-50, March 12, 1982

V. Loans for the Infrastructure of Housing

The total shelter needs of families require more than just the direct financing of constructions and final mortgages. Also needed are services to make a house usable — for example, such private and municipal services as electricity, water, streets, and sewers. Considering all financing requirements to provide adequate housing and related facilities, banks rank near the top of the lending groups. Some of the most recent data available reveal that banks:

Provide $8.5 billion in home improvement loans. 1/

Provide credit assistance to the housing industry indirectly through the loans they make to other housing lenders, such as savings and loan associations, mortgage bankers, life insurance companies, and real estate investment trusts, totaling an estimated $20.9 billion. 1/

1/ Federal Deposit Insurance Corporation, December 1981

As of December 1981, banks held $151.3 billion in municipal securities, nearly 50% of the total. 1/ An estimated $103.0 billion or 68.1% of total bank holdings was issued to finance residential support facilities - schools, roads, utilities and hospitals. This estimate is based on the percentage of 1981 proceeds from new long-term security issues of state and local government used for such purposes.

Use of Proceeds of New Long-Term Security Issues
of
State and Local Governments
1981

Use of Proceeds	Billions of Dollars	Pct. of Total
Public Housing, Hospitals and other Health Institutions	12.1	26.1
Utilities and Conservation Water, Sewer, Electric & Gas and Pollution Control	10.1	21.8
Education Elementary, Secondary, Colleges & Universities	4.6	9.9
Transportation Roads, Bridges, Ports & Airports	3.4	7.3
Parks and other Recreational Facilities	.7	1.5
Fire Stations, Police Stations and other Public Safety and Service Facilities	.7	1.5
Industrial Aid	7.5	16.2
Other Purposes	7.2	15.6
TOTAL	46.3	100.0

Source: Municipal Market Developments, Public Securities Association, February, 1982

Note: Components may not add to totals due to rounding.

1/ FDIC and Federal Reserve Board Flow of Funds Accounts

VI. Measuring the Banking Industry's Contribution to Housing

Residential Mortgage Loans	$187.4 billion
Mobile Home Loans	10.3
Residential Construction Loans	18.5
Federal Housing Agencies Obligations	28.6
Home Improvement Loans	8.5
Loans to Other Housing Lenders	20.9
Municipal Securities Supporting Housing	103.0
	377.2

The $377.2 billion commitment by the banking industry to housing is a rough estimate, but a conservative one. It does not cover an indeterminate amount of loans to contractors, building suppliers and other businesses engaged in housing construction,servicing and supply. But by any standard of measurement, a $377.2 billion investment is a very significant commitment to the housing industry. this puts banks in a close second position to the savings and loan associations in the overall financing of the nation's housing needs.

ATTACHMENT 4

2/22/82

Banking Leadership Conference's
Criteria for Direct Assistance
To Troubled Depository Institutions

1. Any Federal aid should be direct, explicit, and in the budget, so that Congress has to vote specifically on the amount of aid given, and its duration.

2. The aid should be limited to a certain time period and not become institutionalized or automatically extended so that it can be ended after thrifts have made the necessary edjustments needed to become viable.

3. Any assistance should be available on the same terms to all federally insured depository institutions who are experiencing the same difficulties.

4. The assistance should entail serious disincentives to its use so that only institutions who have tried all other ways of alleviating their problems will opt to use it. Such disincentives might include penalty interest rates for long term loans, strictures on the type of business lines institutions may enter, the removal of managements, or refusal to grant FHLBB loans or Federal Reserve loans to institutions that did not properly diversify.

5. The type of assistance extended should be determined by whichever has the minimum present value cost to the agency extending the aid.

Attachment 5

Condition of Insured Banks Requiring Disbursements by FDIC in 1980 and 1981

Date	Bank	Capital as % of Assets[1]	1-4 family mortgages as % of assets	Net income for year[2] ($000's)
1/11/80	Bank of Lake Helen	1.67	15.19	(2145)
2/12/80	First National Bank of Carrington	9.01	2.95	90
2/12/80	Mohawk Bank & Trust	8.09	3.30	4
2/16/80	Citizens State Bank	11.12	6.88	16
6/28/80	City and County Bank of Campbell	5.42	11.32	174
8/8/80	Mission State Bank & Trust	0.11	13.53	(339)
10/11/80	Rochelle Bank And Trust	3.17	10.37	(37)
11/21/80	Citizen State Bank of Galena	6.88	10.95	62
12/31/80	East Gadsden Bank	2.99	29.48	243
3/14/81	South Side Bank	2.14	0.28	(246)
3/14/81	Des Plaines Bank	3.54	12.51	(1448)
3/17/81	Peoples Banking Co.	0.30	10.59	(1015)
6/19/81	Northwest Commerce Bank	5.84	5.88	(114)
9/25/81	Southwestern Bank	4.62	8.66	(149)
10/23/81	High Lakes Community	13.05	1.25	(41)
10/30/81	Midtown National Bank	3.60	2.85	(466)

[1] For banks closed in 1980, capital as a percent of assets is calculated from the books of the bank immediately following closing. Other figures for banks closed in 1980 are from December 1979 call report. Figures for banks closed in 1981 are from December 1980 call reports.

[2] Income is for the year preceding the closing of the bank.

Mr. KENNEDY. Mr. Chairman, I thank you for letting us testify.
Chairman GONZALEZ. We thank you, Mr. Kennedy.
Mr. Harris.

STATEMENT OF S. ALLEN HARRIS III, VICE PRESIDENT, CAPITAL BANK & TRUST CO., BATON ROUGE, LA., ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. HARRIS. In view of the time, I would ask my complete statement be entered into the record, and I will summarize its major points.

Chairman GONZALEZ. Without objection, so ordered.

Mr. HARRIS. First of all, Mr. Chairman, if you will, let me tell you that I have a plane to catch and must leave here about 6 p.m. I have brought along the IBAA's legislative counsel, and should the question and answer period run too long, I would like to be excused if that time comes.

Chairman GONZALEZ. That is fine.

Mr. HARRIS. Thank you very much.

Mr. Chairman, members of the subcommittee, my name is S. Allen Harris III. I am vice president of Capital Bank & Trust Co., of Baton Rouge, La. Capital Bank is a State-chartered commercial bank with assets of $455 million at year-end 1981.

My daily duties involve management of the mortgage portfolio, which totals approximately $50 million.

I am pleased to be testifying today on behalf of the Independent Bankers Association. The IBAA represents about 7,300 national and State-chartered banks located in 48 States and the District of Columbia.

Most IBAA member banks are small, with more than 80 percent having assets of less than $25 million. Most of our banks serve suburban and rural communities. In fact, many of our rural members have an asset structure which is very similar to that of a thrift institution, comprised of a high percentage of residential mortgages.

In a rural community, the IBAA member bank is often the principal local mortgage lender, as well as the principal agricultural lender.

I want to begin by thanking subcommittee chairman Gonzalez for extending an invitation to the IBAA to testify today. The IBAA also wishes to commend Chairman St Germain for his responsibility and foresight in introducing H.R. 5568, a bill which would do much to alleviate the thrift crisis, and which has precipitated a crucial debate regarding depository institution structure and the housing finance system.

This is but a continuation of the leadership first demonstrated by the chairman in guiding the Regulators' Bill to House passage in 1981. Unfortunately, that urgently-needed legislation continues to languish in the Senate Banking Committee.

Earlier this month, the IBAA held its 52nd annual convention. At that meeting, the Association's proposed 1982 resolutions were considered and approved by the thousands of bankers in attendance. Several of those resolutions frame the general principles embodied in our testimony today, and deserve mention at the outset.

One, the IBAA recommends that the administration and the Congress immediately explore potential legislative solutions to the earnings problems affecting thrift institutions, as well as commercial banks possessing significant portfolios of long-term, low-yielding residential mortgages.

Two, while some suggested solutions may cost money, we feel that the decision to incur such liability was made long ago with the establishment of the deposit insurance program. We cannot emphasize too strongly our belief that existing thrift industry problems cannot be solved solely via the merger and acquisition route.

Such action, in combination with enactment of the Regulators' bill and a Federal preemption of usury ceilings, would sufficiently defuse the present crisis so as to permit the depository institutions deregulation committee to authorize competitive products.

The extremely disappointing action taken at the DIDC's March 22 meeting demonstrated that commercial banks will be denied a competitive short-term transaction product until the earnings problems of the thrift is addressed directly.

At this point, I would like to show something and I would enter it in the record, if I could?

Mr. GONZALEZ. Without objection.

Mr. HARRIS. This is a statement stuffer Sears, Roebuck & Co., put in their last bills coming out. It is done in red, white and blue. It has the U.S. Government all over it. I think it mentions the U.S. Government 10 times, by our count. Then, in small print, it is claimed that the instrument is not guaranteed by the U.S. Government nor is Sears backing it up.

In addition, one of the major points that arises out of this money market fund offering is that they are trying to attract deposits of $1,000 minimum, and $50 increments thereafter, which would directly affect the banking industry. This type of competition is why we must have the DIDC take meaningful action.

I would like again to have this put in the record.

Chairman GONZALEZ. Without objection.

[The information follows:]

SEARS U.S. GOVERNMENT MONEY MARKET TRUST

CAUTION: Where you keep your money could be costing you money!

Where you put your hard-earned money is up to you. But consider that putting it someplace where it may only earn a fixed return means your money could end up losing its buying power. If today's inflation continues, your money will have less purchasing power when you take it out than the day you put it in.

The new Sears U.S. Government Money Market Trust was created especially for the millions of Americans, like you, who want to give their money a fighting chance to keep up with inflation.

Since 1978, U.S. Government money market instruments such as those the Trust invests in have paid some of the highest returns available to the average person.

Granted, no one can guarantee what the Sears U.S. Government Money Market Trust—or any other money market fund, for that matter—will do in the future. But you should know that one of our investment objectives, spelled out right in our Prospectus, is high current income. In plain English, that means helping your money work harder than it may ever have before!

Also, you should realize your investment is not insured and the return you receive will fluctuate due to market conditions. But for safety's sake, the Trust invests in securities offered, guaranteed, or backed by the U.S. Government and its agencies.

Here's what Sears U.S. Government Money Market Trust offers you for your hard-earned money...

- Earnings Opportunities. U.S. Government money market instruments have paid some of the highest returns available to the average person. Although there are no guarantees that they will continue to pay high returns, and we cannot promise you that our Trust will equal those earnings, the Sears U.S. Government Trust could offer you higher income on your family's "nest egg."
- Safety. The Trust invests in securities offered, guaranteed, or backed by the U.S. Government and its agencies. Among the investments will be Treasury Bills backed by the "full faith and credit" of the U.S. Government. These types of securities are generally considered the safest investments available if held to maturity.
- Low minimum. Just a $1,000 initial investment opens your account. Add $50 or more anytime.
- Your money's there to use when you need it. You don't have to keep your money "locked-up" for six months, a year or even longer to qualify for money market returns. Take out all or part of your money at any time without penalty.
- No sales charges. There are no charges when you buy or redeem shares. A management fee and certain administrative costs are deducted from the income of the Trust.
- Free check writing. We can send you free checks so you'll have ready cash when you need it—conveniently. Write any number of checks for $500 or more. Additionally, your money keeps on earning income until the check clears!
- Professional management. The Trust is managed by Dean Witter Reynolds InterCapital Inc., a Sears financial services company with assets under management of more than $10 billion.
- Retirement Plans. You can even take advantage of tax benefits for retirement accounts by investing in the Trust through an IRA (Individual Retirement Account) or Keogh Plan. The Trust will provide you with the necessary documents.
- It's easy and convenient. After you open your account, all the recordkeeping is done for you. Every time you buy or redeem shares we'll send you a confirmation, plus we'll keep you informed of the status of your account with regular quarterly statements.

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Mr. HARRIS. Three, the prospect of continuing high Federal deficits for years to come is largely responsible for high long-term interest levels which exacerbate the thrift crisis, and which hurt those sectors of the economy—homebuilding, small business, and agriculture—which are served by the thrift institutions and community-oriented banks. It is therefore imperative that the Congress and the administration get on with the job of bringing our Nation's budget into better balance.

Failure to adopt a fiscal policy which reduces interest rates will not only render the thrift crisis insoluble, but will raise grave concerns about the remaining depository structure and about the future of our borrowers engaged in homebuilding, small business and agriculture.

Mr. Chairman, having stated the general views guiding this testimony, I will now move on to specific comments regarding H.R. 5568.

It is the view of the Independent Bankers Association that immediate Congressional action is required to halt the merger mania which has gripped the deposit insurance agencies. The approach now being developed by Chairman St Germain, that of providing for an exchange of paper between a Federal agency and a housing finance institution in order to preserve a minimum level of net worth, would seem to offer the best immediate means of addressing this situation.

Because it would have an impact on the Federal deficit only in the remote event that liquidation of an institution is necessary, this approach appears to hold out an expeditious means to stabilize the present crisis—if the Congress is serious about reassuring the general public and the financial community through meaningful action which goes beyond the full faith and credit resolution, and is willing to demonstrate that seriousness of purpose by keeping this net worth legislation free of extraneous and highly controversial amendments.

Although thrift institutions would comprise the vast majority of the recipients of aid under the proposal, there may well be a small number of commercial banks with mortgage portfolios in excess of 20 percent of assets who face critical net worth problems.

Speaking from my own experience, while my bank's mortgage portfolio comprises only about 11 percent of assets, and only about 5 percent of that portion carry interest rates below 8.5 percent, that small batch of below-market mortgages creates substantial cash flow problems.

Therefore, I am in a good position to understand the severe difficulties which afflict a bank carrying a larger portfolio comprised of a greater portion of below-market rate mortgages.

On behalf of the IBAA, I would urge that the legislation be perfected to permit participation by those commercial banks who require such assistance. This will require a recognition that the 2-percent net worth level specified in the initial bill is irrelevant to commercial banks, as we are subject to different and more stringent operating requirements and would be unlikely to be permitted to fall below a 6-percent net worth requirement of our regulators.

As for the requirement that assisted institutions reinvest a portion of the aid they recieve in housing finance, we certainly recog-

nize the political realities which underlie this portion of the legislation.

However, we would urge that the requirement be broadened to include such avenues of investment as home improvement and rehabilitation loans, mortgage-backed securities, and multifamily mortgages.

We would also urge that distressed institutions not be required to extend fixed-rate mortgages at interest levels which perpetuate earnings losses, as such as requirement would be self-defeating.

Finally, I think it is stating the obvious to observe that a revitalization of the homebuilding industry cannot rest solely on the efforts of the most severely afflicted financial institutions, but must be based upon a variety of complementary strategies.

H.R. 5568 can help forestall the disaster that would befall the banking structure were the Federal Reserve to permit takeovers of savings and loans by bank holding companies by expanding the scope of section 4(c)(8) of the Bank Holding Company Act.

Net worth stabilization's most significant effect will be to buy time. What can this breathing space be used for? First and foremost, it should be used to construct a fiscal policy which brings down interest rates.

But it should also be utilized to consider whether additional steps should be taken to assist the thrift industry. We believe this committee and the entire Congress should ask the following questions in that regard:

Is additional assistance required to maintain public confidence in the entire depository system?

Is additional assistance required to permit deregulation measures which give depository institutions the products necessary for effective competition with nonregulated financial firms?

Is additional assistance required to preserve the decisionmaking role of the Congress on the basic policy issues? Continuation of the merger waive will effectively void a large body of State and Federal law. This committee's role could be well reduced to that of rubber stamping a fait accompli.

Basic structural changes should result from careful deliberation, not secret weekend mergers. Individual institutions should not be protected from competition, but neither should they be destroyed by mishandling of the depository transition period.

Is additional assistance a cost-effective solution? The Congress must realize that the decision to make no action beyond net worth stabilization is not a no-cost decision.

A study just released by Wharton Econometrics Forecasting Associates projects that assistance by merger could cost more than twice as much as direct assistance via mortgage warehouses.

It is imperative that the Congress review that analysis and evaluate its accuracy. No one likes to contemplate a thrift-assistance program costing billions at a time when projected Federal deficits are so staggering. But the cost is there, and it will be paid one way or the other.

To sum up, the Congress should first act to buy time by enacting, as soon as possible, the net worth stabilization plan.

The Senate should immediately pass the Regulators' bill, as Chairman Volcker has repeatedly urged, rather than continue to

hat legislation hostage to highly controversial restructuring als.

Congress should then use the time these actions buy to whether additional measures are required to further sound policy, effectuate depository deregulation, ensure public con- . and keep the costs of the thrift crisis at a minimum over g run.

ld the Congress determine that a mortgage warehousing the best means of achieving these ends, it would be the posi- the IBAA that commercial banks with residential portfolios ss of 20 percent of assets should be eligible for participation.

hairman, in closing, we must comment upon the arguments ve heard in recent weeks that the thrift institutions can irvive if their specialized housing finance role is terminated. e we believe that some immediate response is required for erall stability of the depository system, we also recognize ongress must consider the future role of the thrifts as it pon- e extent of the aid it will extend.

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IBAA's opposition to the granting of commercial account ding powers to thrifts is based upon the damage this would upon the financial structure, in advance of adequate Con- l deliberation regarding the underlying public policy con- , including the issue of the institutional structure for the ncing of the Nation's housing needs.

nsistent to advocate massive interest rate subsidy pro- r home buyers while at the same time allowing the thrift quietly die

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Commercial bank power offers significant aid only in the long run. But sticking to the first two preserves a specialized source of housing finance, and does not begin the process of homogenization and centralization of financial institutions.

We would urge that Congress first observe whether these new instruments are sufficient to reduce the interest rate exposure of the thrifts once their earnings improve, before embarking on a radical restructuring of the financial system.

Mr. Chairman, this concludes my testimony on behalf of the IBAA. The independent commercial banks of the United States are ready to play their role in the revitalization of our national economy.

However, in order to do so, the Congress must take forthright actions to address the thrift crisis and the continuing problem of record high real interest rates.

The IBAA stands ready to offer any assistance it can in perfecting and advancing legislation which addresses these crucial areas. Again, we thank you for this opportunity to present our views today.

[Mr. Harris' prepared statement, on behalf of the Independent Bankers Association of America, follows:]

S T A T E M E N T

OF THE

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

BEFORE THE

HOUSE BANKING COMMITTEE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

REGARDING

THE HOME MORTGAGE CAPITAL STABILITY ACT

H. R. 5568

March 31, 1982

Good afternoon, Mr. Chairman and Members of the Subcommittee, my name is S. Allen Harris, III. I am Vice President of the Capital Bank and Trust Company of Baton Rouge, Louisiana. The Capital Bank is a state-chartered commercial bank with $455 million in assets as of the end of 1981. My daily duties involve management of the bank's mortgage portfolio, which totals approximately $50 million.

I am pleased to be testifying today on behalf of the Independent Bankers Association of America (IBAA). The IBAA represents approximately 7300 national and state-chartered banks located in 48 states and the District of Columbia. Most IBAA member banks are small, with more than 80 percent having assets of less than $25 million. And most of our banks serve suburban and rural communities. In fact, many of our rural members have an asset structure which is very similar to that of a thrift institution, comprised of a high percentage of residential mortgages. In a rural community, the IBAA member bank is often the principal local mortgage lender, as well as the principal agricultural lender.

I want to begin by thanking Subcommittee Chairman Gonzalez for extending an invitation to the IBAA to testify today. The IBAA also wishes to commend Chairman St Germain for his responsibility and foresight in introducing H.R. 5568, a bill which would do much to alleviate the thrift crisis, and which has precipitated a crucial debate regarding depository institution structure and the housing finance system. This is but a continuation of the leadership first demonstrated by the Chairman in guiding the Regulators' Bill to House passage in 1981--unfortunately, that urgently needed legislation continues to languish in the Senate Banking Committee.

Earlier this month, the IBAA held its 52nd Annual Convention. At that meeting, the Association's proposed 1982 Resolutions were considered and approved by the thousands of bankers in attendance. Several of those Resolutions frame the general principles embodied in our testimony today, and deserve mention at the outset--

--The IBAA recommends that the Administration and the Congress immediately explore potential legislative solutions to the earnings problems afflicting thrift institutions, as well as commercial banks possessing significant portfolios of long-term, low-yielding residential mortgages. While some suggested solutions may

cost money, we feel that the decision to incur such liability was made long ago with the establishment of the deposit insurance program. We cannot emphasize too strongly our belief that existing thrift industry problems cannot be solved solely via the merger and acquisition route.

--Such action, in combination with enactment of the Regulators' Bill and a Federal preemption of usury ceilings, would sufficiently defuse the present crisis so as to permit the Depository Institutions Deregulation Committee (DIDC) to authorize competitive products. The extremely disappointing action taken at the DIDC's March 22 meeting demonstrated that the Deregulation Committee continues to be whipsawed between the need of banks for a competitive short-term transaction product, and the inability of thrifts to offer such a product due to their earnings problems. The instrument approved by the DIDC is antithetical to the spirit of deregulation in its reestablishment of a differential. Its $7,500 minimum deposit and lack of a transaction feature render it noncompetitive with the unregulated money market funds. It will do little for depository institutions as a whole, but may succeed in shifting a small portion of deposits from commercial banks to thrifts as well as shifting funds from existing passbook accounts.

--The prospect of continuing high Federal deficits

for years to come is largely responsible for high long-term interest levels which exacerbate the thrift crisis, and which hurt those sectors of the economy--homebuilding, small business, and agriculture--which are served by thrift institutions and community-oriented banks. It is therefore imperative that the Congress and the Administration get on with the job of bringing our nation's budget into better balance.

Failure to adopt a fiscal policy which reduces interest rates will not only render the thrift crisis insoluble, but will raise grave concerns about the remaining depository structure and about the future of our borrowers engaged in homebuilding, small business, and agriculture.

Mr. Chairman, having stated the general views guiding this testimony, I will now move on to specific comments regarding H.R. 5568.

It is the view of the Independent Bankers Association that immediate Congressional action is required to halt the merger mania which has gripped the deposit insurance agencies. The approach now being developed by Chairman St Germain, that of providing for an exchange of paper between a Federal agency and a housing finance institution in order to preserve a minimum level of net worth, would seem to offer the best immediate means of

addressing this situation. Because it would have an impact on the Federal deficit only in the remote event that liquidation of an institution is necessary, this approach appears to hold out an expeditious means to stabilize the present crisis--if the Congress is serious about reassuring the general public and the financial community through meaningful action which goes beyond the "Full Faith and Credit" Resolution, and is willing to demonstrate that seriousness of purpose by keeping this net worth legislation free of extraneous and highly controversial amendments.

Although thrift institutions would comprise the vast majority of the recipients of aid under the proposal, there may well be a small number of commercial banks with mortgage portfolios in excess of twenty percent of assets who face critical net worth problems. Speaking from my own experience, while my bank's mortgage portfolio comprises only about eleven percent of assets, and only about five percent of the mortgages within that portfolio carry interest rates below the 8 1/2 percent level, that small batch of below- market mortgages creates substantial cash flow problems. Therefore, I am in a good position to understand the severe difficulties which afflict a bank carrying a larger portfolio comprised of a greater portion of below-market rate mortgages. On behalf of the IBAA, I would urge that the legislation be perfected to permit participation by those commercial banks who require such

assistance. This will require a recognition that the two percent net worth level specified in the initial bill is irrelevant to commercial banks, as we are subject to different and more stringent operating requirements and would be unlikely to be permitted to fall below a six percent net worth level by our regulators.

As for the requirement that assisted institutions reinvest a portion of the aid they receive in housing finance, we certainly recognize the political realities which underlie this portion of the legislation. However, we would urge that the requirement be broadened to include such avenues of investment as home improvement and rehabilitation loans, mortgage-backed securities, and multi-family mortgages. We would also urge that distressed institutions not be required to extend fixed-rate mortgages at interest levels which perpetuate earnings losses, as such a requirement would be self-defeating. Finally, I think it is stating the obvious to observe that a revitalization of the homebuilding industry cannot rest solely on the efforts of the most severely afflicted financial institutions, but must be based upon a variety of complementary strategies.

The enactment of legislation shoring up the net worth of distressed depository institutions will have some salutary effects. It can bring the rush of mergers to a virtual halt, and thereby limit the financial

concentration and loss of local control which accompanies such actions. And it avoids the disastrous impact on our financial structure that would result were the Federal Reserve Board to permit the takeover of a savings and loan by a bank holding company under Section 4(c)(8) of the Bank Holding Company Act. Were that to occur, it would undermine the intrastate branching systems of the separate states, erase the boundary line between banking and commerce, and erode the Douglas Amendment to the Bank Holding Company Act. Over time, this would destroy that embodiment of Federalism in the economic sphere which accords the states a dominant voice in determining the financial structure within their borders. This system recognizes the importance of local decision-making in the granting of credit, and the dangers of excessive financial concentration.

Net worth stabilization's most significant effect will be to buy time. What can this breathing space be used for? First and foremost, it should be used to construct a fiscal policy which brings down interest rates. But it should also be utilized to consider whether additional steps should be taken to assist the thrift industry. We believe this Committee and the entire Congress should ask the following questions in that regard:

--Is additional assistance required to maintain

public confidence in the entire depository system? In recent weeks, we have seen a television show trigger a run on a Connecticut thrift institution. We have seen a Newsweek cover story help spur the Congress to enact a Resolution declaring that the full faith and credit of the Federal government stands behind insured deposits. We have seen public statements pointing to the demise of up to 1,000 thrifts.

Recogdizing that a net worth plan does nothing to cure the underlying malaise of thrift institutions--their low-yield mortgage portfolios--there is a likelihood that continued deterioration of their earnings would require large-scale mergers in the future. At that time, as daily announcements of assisted mergers and the accompanying diminution of the insurance funds again inflames public concern, there will remain the possibility of a general crisis of confidence in our financial system.

--Is additional assistance required to permit deregulation measures which give depository institutions the products necessary for effective competition with nonregulated financial firms? We must observe that, to date, the DIDC has proved unwilling to let commercial banks compete head-on with the Money Market Funds because to do so would simply accelerate the demise of the thrifts. In turn, the free market philosophy of this Administration has adamantly opposed any reserve

requirements, capital requirements, or insurance requirements on such funds. Such requirements have served our financial system well, but now, apparently, they are out of bounds for institutions holding close to $200 billion in deposits. By holding commercial banks hostage to the thrift crisis, the DIDC is jeopardizing the future health of the entire depository system. This logjam must be broken. It is for Congress to decide whether direct assistance to the thrifts is the only means of achieving that end.

--Is additional assistance required to preserve the decision-making role of the Congress on basic public policy issues? As we have described, a continued merger wave, particularly were it to involve bank holding company takeovers of savings and loans--and, again, this seems to be a deliberate policy of this Administration--will effectively void a large body of state and Federal law. This Committee would be reduced to rubberstamping a fait accompli. The IBAA does not think that is the proper role for the Congress.

If changes in the financial structure are to come, they should be the result of careful and reasoned deliberation, not secret weekend mergers. If individual institutions are to disappear, it should be because they have been eliminated by free competition, and not because the deregulation transition period has been mishandled.

--Is additional assistance a cost-effective solution? The Congress must realize that the decision to take no action beyond net worth stabilization is not a no-cost decision. Most estimates of the cost of this avenue, if high interest rates result in protracted earnings losses, fall in the area of 1,000 merged institutions by the end of 1983, the complete draw-down of the FSLIC fund, and the drastic reduction of the FDIC fund. We would interject that FDIC losses result in foregone insurance rebates to commercial banks, which reduces their profitability and exacerbates their problems. A study just released by Wharton Econometric Forecasting Associates projects that assistance by merger could cost more than twice as much as direct assistance via mortgage warehousing. It is imperative that the Congress review that analysis and evaluate its accuracy.

No one likes to contemplate a thrift assistance program costing billions at a time when projected Federal deficits are staggering. But the cost is there, and it will be paid one way or another. Although the Treasury Department testified one week ago that the Congress need do nothing about the thrift crisis, it is clear that the Secretary of the Treasury recognizes the potential liability to the Federal government. In a March 9 Westinghouse Broadcasting interview, Treasury Secretary Regan stated, "The United States government is not going

to let depositors lose their money in savings and loans...We are quite ready to inject capital or other things into that industry if need be in order to save them until such time as interest rates come down and they can again get their batteries charged up."

To sum up, the Congress should first act to buy time by enacting, as soon as possible, a net worth stabilization plan. And the Senate should immediately pass the Regulators' Bill, as Chairman Volcker has repeatedly urged, rather than continue to hold this legislation hostage to highly controversial restructuring proposals. The Congress should then use the time these actions buy to assess whether additional measures are required to further sound public policy, effectuate depository deregulation, ensure public confidence, and keep the costs of the thrift crisis at a minimum over the long-run.

Should the Congress determine that a mortgage warehousing plan is the best means of achieving these ends, it would be the position of the IBAA that commercial banks with residential mortgage portfolios in excess of twenty percent of assets should be eligible for participation. Such institutions would have demonstrated their commitment to housing finance and are facing the same earnings problems as thrift institutions. Many small commercial banks not only have asset structures similar to

thrift institutions, but also similar liability structures. About one-third of the deposits in thrift institutions are subject to market-determined ceilings. For small banks, the average is one-quarter of deposits. However, large commercial banks with assets of more than $100 million have, on the average, only ten percent of their deposits carrying market-determined ceilings.

Mr. Chairman, in closing, we must comment upon the arguments you have heard in recent weeks that the thrift institutions can only survive if their specialized housing finance role is terminated. While we believe that some immediate response is required for the overall stability of the depository system, we also recognize that Congress must consider the future role of the thrifts as it ponders the extent of the aid it will extend.

To put the question succinctly, if the thrifts are to be saved, to what end will they be saved?

The IBAA's opposition to the granting of commercial account and lending powers to thrifts is based upon the damage this would wreak upon the financial structure, in advance of adequate Congressional deliberation regarding the underlying public policy considerations, including the issue of the institutional structure for the future financing of our nation's housing needs. Is it inconsistent to advance massive interest rate subsidy

programs for home buyers while at the same time allowing the thrift industry to quietly die?

It is widely acknowledged that the granting of such commercial banking powers would do nothing to solve the present thrift crisis, and could even worsen the condition of individual thrifts who use such powers in a hasty and unwise manner. However, you are told, such a diversification of the asset mix is required if the Nation is to avoid a repetition of the present crisis. Diversified asset powers do not ensure profitability, only portfolio yield diversification and flexibility.

But commercial powers are not the only route to that objective. As a matter of fact, thrifts have recently acquired two new means to that same end. The first is the ability to offer variable-rate mortgages, which shift a portion of the interest rate risk from lender to borrower. The second is the authority, granted last year, to hedge interest rate risks in the futures market.

It is not generally recognized that this hedging ability could have an astounding impact on the condition of the thrifts. In the March 8, 1982 Business Week, Reid Nagle, Senior Vice-President of City Federal Savings and Loan Association in Elizabeth, New Jersey, is quoted as estimating that the granting of this power several years earlier could have improved the profitability of the

thrift industry by $16 billion in 1981. Had that occured, we would not be sitting in this hearing room today. By selling short GNMA futures contracts against its fixed-rate mortgages, City Federal has, according to Mr. Nagle, created an "asset hedge" which "has the effect of transforming fixed-rate assets into variable rate assets".

Similarly, hedging can be utilized to achieve a better match between assets and liabilities by applying this tool to the liability side of the equation. By selling short against its short-term fixed-rate liabilities, an institution may fix its cost of borrowed money over a far longer period. In the March 23, 1982 American Banker, Sanford Rose observes, "If the savings banks and savings and loans had undertaken to hedge their money-market certificates when the certificates were first introduced in May 1978, there would today be no crisis in the thrift industry. Those savings banks that have so far failed, or will fail, would have survived."

So, with twenty-twenty hindsight, we can see that the current thrift crisis was not inevitable. But it is a reality, and it must be addressed. Hedging and VRMs offer significant aid only in the long run, but the same is true of commercial lending powers. However, unlike a grant of commercial powers, they preserve a specialized source of finance for the key housing sector and do not set in

motion a process of financial homogenization and concentration. We would urge that the Congress first observe whether these new instruments are sufficient to reduce the interest rate exposure of the thrifts once their earnings improve, before embarking on a radical restructuring of the financial system.

Mr. Chairman, this concludes my testimony on behalf of the IBAA. The independent commercial banks of the United States are ready to play their role in the revitalization of our national economoy. However, in order to do so, the Congress must take forthright actions to address the thrift crisis and the continuing problem of record-high real interest rates. The IBAA stands ready to offer any assistance it can in perfecting and advancing legislation which addresses these crucial areas. Again, we thank you for this opportunity to present our views today.

# # #

Chairman GONZALEZ. Thank you, Mr. Harris, for a very perceptive presentation. In view of your time constraint, I hope your pony is saddled, and you are spurred and will be leaving from National and not Dulles, because you don't have much time.

In view of that, I intend to turn this over to the author of the bill, the chairman of the full committee, Mr. St Germain, for any possible questions he may have before you leave.

As far as I am concerned, I am going to ask unanimous consent to submit a couple of questions that I thought I would ask.

If it is all right with you, we will recognize Mr. St Germain.

Mr. ST GERMAIN. Thank you, Mr. Chairman. Mr. Harris, first we thank you for your statement.

Second, Mr. Kennedy talks about all the institutions under $100 million in the ABA. I wonder why he didn't consult with you, because your statements don't seem too much in concert.

But with respect to what both of you state that no commercial banks qualify since capital requirements are different than those of the thrift institutions, you thus recommend the provision be tightened to make qualification of banks a real possibility.

If you would, I would ask you to work with your staff and submit my staff recommendations that would achieve that which you so that we could look at it very carefully.

Certainly, most of us who have been here a while appreciate the fact that many of the small banks around the country have indeed done their job as far as home mortgage lending is concerned.

Certainly, they should not be precluded from assistance if their problems ensue as a result of having accomplished this mission. We don't want to preclude assistance there if it can be done feasibly. I thank you for your statement.

We have questions to submit to your organization in writing, but on that point, I will ask you to get back to us.

Mr. HARRIS. Again, if you have anything later, a representative of IBAA will be here.

Mr. ST GERMAIN. Thank you very much.

Chairman GONZALEZ. Mr. Wylie.

Mr. WYLIE. Thank you for an excellent statement.

Chairman GONZALEZ. Thank you very much, Mr. Harris.

With that, why, we dismiss you and offer you a chance to catch that plane. I hope it is from National.

Mr. HARRIS. Yes.

Chairman GONZALEZ. You should be able to do it. Thank you again for your time.

Mr. Carron, thank you for your patience. We appreciate your yielding.

STATEMENT OF ANDREW S. CARRON, RESEARCH ASSOCIATE, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION

Mr. CARRON. Mr. Chairman, I am pleased to accept your invitation to appear today and discuss the current problems of the Nation's savings institutions and the housing industry.

I have been analyzing these subjects intensively for the past year and a half. Many of the results of my study were published by Brookings last month in a book, The Plight of the Thrift Institutions. My testimony today will draw on the material contained in the book, as well as on additional research conducted since the book went to press.

I would like to divide my testimony into three parts: The circumstances leading up to the situation we have today; the outlook for the thrift industry in 1982, 1983 and beyond; and my comments on H.R. 5568, the Home Mortgage Capital Stability Act, as a means of addressing the problems. The origins of the problems in our housing finance system are wellknown by now, so I shall touch on them only briefly in my remarks this afternoon.

I would ask that my entire statement be included in the record.

Chairman GONZALEZ. Without objection, so ordered.

Mr. CARRON. Thrift institutions grew and prospered under a regulatory framework that led them to specialize in long-term fixed-rate mortgage lending and short-term deposit taking. The system functioned smoothly as long as interest rates remained steady. Deposit rate ceilings were imposed in the mid-1960's to restrain the cost of funds to institutions as market interest rates began to rise.

The thrift industry, despite periodic setbacks, gave the appearance of health during most of the 1970's. Assets of the more than 5,000 savings and loan associations and mutual savings banks tripled over the decade, exceeding $800 billion in 1980. The thrift

stitutions were the major source of new funds for housing during this period.

The ratio of net worth to assets of the thrift industry—a measure of long-term viability—fell continuously during the 1970's, however, indicating difficult times to follow. Deposit rates, which affect the cost of an institution's liabilities, were gradually becoming more sensitive to market changes as the result of administrative and legislative deregulation. Rates of return on the asset portfolios of thrift institutions remained locked into earlier lower levels by the long-term nature of mortgages and by regulations limiting diversification. When interest rates rose to record levels in 1980 and 1981, deposit flows and mortgage lending slowed, the cost of funds rose sharply, and profits turned negative.

During 1981, the savings and loan associations lost $4.9 billion, their first loss in recent history. The mutual savings banks lost $1.5 billion last year following a smaller loss in 1980. Net worth declined sharply, and the thrift industry began sliding toward insolvency. Last month, the savings and loan industry's net worth fell below 4 percent of assets.

It should be stressed that this trend is a long-term problem of profitability and viability, and does not affect the routine operation of individual firms. Customers will continue to receive normal deposit and lending services throughout the period of adjustment.

Liquidity—the availability of cash to meet normal business needs—has not been a problem for the thrift industry as a whole. Potential cash shortages have been avoided through a reduction in new lending and through increased borrowing.

I will now review the near-term outlook for the thrift industry. As part of my research, I constructed a computer model to forecast the earnings and financial condition of the thrift industry. The results showed that structural changes will be required.

A sizable minority of savings and loan associations will never return to profitability on their own, even under optimistic economic assumptions, and a much smaller number of mutual savings banks will be similarly affected. More than 400 firms—mostly small and inefficient, but with ample resources—must find merger partners to avoid potentially irreversible losses of net worth. Still others—at least 200, and possibly more than 600 under adverse economic conditions—may require financial assistance from the deposit insurance agencies to arrange mergers. A few closings and liquidations may occur.

In my book, I calculated the performance of the industry under three sets of assumptions, which I labeled optimistic, consensus, and pessimistic.

Since the book was published a month ago, there has been much discussion over the validity of particular assumptions. It should be noted that the fundamental results remain the same regardless of the assumptions; small differences in numbers of institutions affected and required assistance do not change the policy recommendations.

That is largely because the damage from regulation and high interest rates has already been done.

It should be apparent that the evolution of the industry over the next few years has been largely predetermined, and only the ac-

counting rules that emphasize historical costs have prevented a widespread realization of the fact. Because of the losses which have already been incurred, many firms simply will not survive unassisted.

Required assistance to the thrift industry will be reflected in a significant impact on the budget, regardless of what policies are chosen. Assuming consolidation is encouraged to proceed, the net costs of assistance from the Federal Savings and Loan Insurance Corporation would exceed $6 billion and the Federal Deposit Insurance Corporation would be called upon to supply over $2 billion. These amounts include the expenditure exceeding $1 billion by the FSLIC and $700 million by the FDIC in 1981; the remainder would be paid out in some form over the next 5 to 10 years.

Preservation of the industry with its current structure would necessitate large operating subsidies for the next few years and smaller infusions after that. The existence of many small firms does provide opportunities for local control and specialized attention to local needs. The drawback, however, is operating inefficiency. With increased homogenization of financial markets and institutions, and with depositors becoming more aware of alternative uses for their savings, the specialized local thrift institution is less viable than in the past.

One potentially troubling factor that has only recently come to light is the increased flow of deposits out of thrift institutions.

Deposit flows have fallen at times in the past, as individuals sought higher interest rates outside the regulated banking and thrift sector. The concern now is that people appear to be shifting money into commercial banks, sometimes accepting a lower interest rate to do so. After correcting for interest rate differentials and other relevant factors, the data indicate that one-third of the deposit outflows in the current episode represent shifts from thrifts to banks.

The only plausible explanation is that some people now believe banks are safe and thrifts are not. The regulatory agencies call this the quiet run.

The thrift industry cannot sustain this rate of losses indefinitely. Over the near-term, the institutions can adapt by curtailing their new lending, leaving it to other sectors to provide funds for housing. Table 2 shows the historical and recent deposit flows for thrifts, banks and money market mutual funds.

Table 3 shows that the reduced deposit flows have been reflected in a reduced amount of new lending. Once the principal source of housing funds, the thrifts now trail commercial banks.

For the future, however, the quiet run poses two dangers: One is the possibility that it will turn into an all-out run on the thrift institutions. While I do not expect this to happen, such a run would create havoc in financial markets, demolish the hope of a stable monetary policy, and inflict serious damage on the national economy.

The other concern is that the quiet run will continue, slowly draining the resources of the thrift industry. At the time I wrote my book, this did not appear likely, and I did not think any new policy was required. Now, with more data available, I feel that the liquidity problem is one that must be addressed.

Even if deposit inflows are restored, however, the role of thrift institutions in the mortgage market will change. Housing finance will not be as abundant or as cheap as it was in the past, but the larger and more diversified thrift institutions that survive will continue as major sources of mortgage credit.

Expertise in originating and servicing mortgage loans is a major asset of the thrift industry and one it is likely to exploit. New sources of lending and retail banking will move in to preserve service and competition if the thrifts fail to do so.

I will now turn to the specific legislation before the subcommittee.

There are a number of ways available to manage the transition to deregulation. Left alone, most problem thrift institutions would arrange voluntary mergers. Many would ultimately fail, requiring the deposit insurance agencies to pay off account holders.

This process would take place over several years. At the discretion of the regulators, action could be taken sooner to arrange mergers or liquidations, and this could be less costly.

The FSLIC has also begun a limited assistance program through the use of income capital certificates. Other policy instruments have been and will be used to prop up the industry, principally the all savers certificate and deposit rate ceilings.

All of these plans share the common ingredient necessary for success: They include a subsidy to offset the losses incurred by failing institutions on their old low-rate mortgages.

This subsidy is not a bailout, or at least not a new one. The decision to assist failing institutions was made when Congress created deposit insurance; economic circumstances then put the institutions in an untenable position.

But the assistance plans are not equally efficient in forming transition policies of the thrift industry. Meeting the goal of efficient and effective policy will depend upon supplying efficient aid to the firms that require it and withholding it from those who would not.

H.R. 5568, the Home Mortgage Stability Act begins to address these issues. It contains many elements which, with the appropriate modifications, could go far to solve the transition problems of the thrift and housing sectors. In its specifics, however, the legislation would reward inefficiency, exceed cost estimates, harm the long-run viability of the housing finance system, and exacerbate the confidence crisis. Moreover, as drafted, it would not be completely effective in resolving the transition difficulties of the thrift industry: Additional billions would still be required to aid hundreds of failing institutions.

With regard to capital participation notes: The principal of injecting capital into ailing but viable institutions is a good one. The FSLIC is already using income capital certificates in a program to supply resources to institutions. Along with the assistance come stringent operating requirements. Such plans are intended to give an institution time to work out problems on its own, and to give the FSLIC time to arrange a merger should that become necessary. I understand that the sponsors of H.R. 5568 intend to structure the capital program as an exchange of notes which would result in no immediate budget impact; the cost of such assistance would then be

reflected in the interest payments to the savings and loan on the FSLICs notes.

There are a few other technical changes that are required to assure that the capital maintenance program would be feasible, efficient, and effective. These are detailed in my prepared statement and I will not go into them here.

Some depository institutions may require a short-term subsidy to permit them to become viable over the long run. Where this assistance would be less costly than merger or liquidation, both in terms of direct outlays and social costs, it is highly avisable. The stabilization plan outlined in H.R. 5568 can be made operable if the following technical problems are addressed in the committee's deliberations:

First, the same perverse incentives to incur losses present with the capital participation notes exist with respect to the income assistance: Larger losses induce larger subsidies. On the contrary, banks and associations should be encouraged to reduce their losses.

Second, although the plan calls for repayments to begin no later than 5 years after the assistance is rendered, many institutions may have no net after-tax income with which to make the required payments. This element must be modified in any case to structure the capital participation notes as capital rather than debt.

The best way to resolve these difficulties would be to set a market rate of interest on the agency obligations transferred to the problem institution, rather than to make the payments on the basis of losses. This would encourage reduction of expenses, sound investment decisions, and a rapid return to health. It would also prevent open-ended subsidies to institutions which are not likely to survive, and which would thus be unable to repay the assistance.

Moving on to the Home Mortgage Capital Stability Fund: H.R. 5568, as introduced, envisioned the creation of a $7.5 billion fund at the Treasury to purchase the capital participation notes of institutions. Now that the legislation is to be modified, so that assistance would be provided with paper rather than cash, this fund is no longer required. However, in order to satisfy acocunting standards and maintain credibility in financial markets, some backing for the notes of the agencies is still necessary. This could be provided through an increase in the agencies' borrowing authority at the Treasury; probably only the FSLIC would require an increase, as it has the largest obligations and only a $750 million line of credit.

Alternatively—and preferably—the obligations of the FSLIC, FDIC, and National Credit Union Administration could be made explicit obligations of the Federal Government. This would serve a dual purpose: it would provide the necessary financial backing for agency notes, and it would reassure depositors that their savings are indeed protected.

In many institutions, the liabilities not covered by insurance have been reduced or withdrawn for fear of default. We heard that in the earlier panel this afternoon. Moreover, as noted above, even insured depositors are withdrawing their funds, as the resources of the insurance agencies are seen to be in doubt.

Title III of the National Housing Act (12 U.S.C. 1721), which pertains to the obligations of the Government National Mortgage Association, states:

The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty under this subsection.

A similar provision, subsituting the word insurance for guaranty, could be added to title IV of the same act (12 U.S.C. 1726) which pertains to the duties of the FSLIC. It would also be advisable to make comparable amendments to the Banking Act of 1933 (12 U.S.C. 1811) which established the FDIC, and to the Federal Credit Union Act (12 U.S.C. 1781) which established the National Credit Union Administration and the National Credit Union Share Insurance Fund.

There would be no budgetary impact to either an extension of full faith and credit or to increased borrowing authority, unless and until expenditures were made. But since it is universally acknowledged that the insurance obligations would be met in any and all circumstances, there would certainly be no additional impact on the budget from either policy. Moreover, by reassuring depositors, liquidity would be improved, lessening the burden on the regulatory agencies.

H.R. 5568 would require institutions receiving capital and earnings assistance to invest at least 50 percent of net new deposits in residential mortgages for first-time home buyers at below-market rates. The thrift institutions' problems derive in large part from the preponderance of a single type of instrument in their asset portfolios—the long-term fixed-rate residential mortgage.

Regulations and tax law precluded institutions from doing much else. The expanded asset powers permitted by the Depository Institutions Deregulation and Monetary Control Act of 1980 and those proposed in subsequent legislation are intended to reduce the balance sheet vulnerability of thrift institutions and to foster equality among financial institutions. The new powers are vital to the future health of thrifts that survive the current transition problems.

As a matter of choice, most thrift institutions will continue to invest at least 50 percent of net new deposits in mortgage loans in any event, but the rate and allocation requirements in the proposed legislation are unworkable. The bill sets a mortgage rate limited to 1 percentage point over the institution's average cost of funds. This average is composed of existing deposits, many in passbook and fixed-rate accounts, as well as the net new deposits received at much higher rates.

But the new mortgages will have to be financed not out of the old funds at average rates, but out of the new deposits at the much higher marginal or market rates. The marginal cost of new deposits, as reflected in the rates on money-market and small-savers certificates, range from 13 to over 14 percent.

Savings and loan associations today have an average cost of funds of about 11.5 percent, implying that new mortgages under the act would be written at 12.5 percent rather than the current 15 percent market rate for mortgage loans closed. Subtract 1 percentage point from the mortgage yield for the cost of servicing the mortgage, and the implication is that an institution would lose money on such transactions.

Let's talk about mergers. The principal means used so far to address the problems of the thrift industry has been merger.

If H.R. 5568 were to pass, appropriately modified, the need for substantial numbers of mergers would not be eliminated. The bill, by its focus on institutions with reasonable prospects for long-term viability, correctly does not seek to forestall the necessary process of consolidation. This policy, if properly executed, will reduce the administrative and financial burden on the agencies, thereby cutting budgetary expenditures as well.

In concluson, the programs in place today will prove adequate only if there is a major improvement in economic conditions that retards the pace and reduces the level of thrift industry losses. The deposit insurance agencies will play a crucial role in any event. Net costs of assistance at $6.5 billion for the FSLIC and $2.1 billion for the FDIC are within the capabilities of the agencies.

In the case of the FSLIC, however, the margin is slim, even though the costs will be spread over several years. The number and gross cost of the transactions could overwhelm the agency's administrative capabilities and impair its liquidity.

The most urgent change needed in current policy is an enhancement in the powers and resources of the FSLIC. Ideally, the agency, in concert with the executive branch and Congress, would develop a comprehensive program to subsidize, merge, or sell off those few hundred associations that are virtually certain to require assistance. This plan should be implemented rapidly, thereby ending the erosion of firms' assets, minimizing market uncertainty, and preserving public confidence in the agency's ability to protect depositors.

Arrangements should also be made to bolster the agency's resources. Additional standby borrowing authority at the Treasury may be sufficient, but putting the full faith and credit of the Federal Government behind the obligations of the insurance agencies is preferable. Thus prepared, the restructuring of the financial sector can proceed with minimal disruption to markets, adequate protection for depositors, and the least cost.

Should it be decided that some form of broad subsidy is desirable, additional budgetary expenditures will be required. Such programs, however, must be justified in their own merits, as they are not necessary for protecting depositors, maintaining public confidence, or restoring the viability of the financial system.

Once the issue of nonviable thrift institutions is resolved, the question of the housing industry recurs. Some modest changes to relax credit market barriers, such as permitting more flexible mortgage instruments, are appropriate. Beyond that, economics has little to propose, the issue being one of social policy.

Congress may decide that the equilibrium supply of housing is inadequate in an unregulated market and seek to shift the distribution of resources back into the sector. But the depressed condition of the housing industry today is due to interest rates and recession, and is more the cause than the result of the thrift industry's problems.

Thank you.

[Mr. Carron's prepared statement follows:]

Statement of

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Prepared for delivery before the

Subcommittee on Housing and Community Development

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

March 31, 1982

Mr. Chairman, my name is Andrew S. Carron. I am a research associate in the Economic Studies Program at the Brookings Institution. The views expressed here are mine alone, and should not be ascribed to the trustees, officers, or other staff members of the Brookings Institution.

I am pleased to accept your invitation to appear today and discuss the current problems of the nation's savings institutions and the housing industry. I have been analyzing these subjects intensively for the past year and a half. Many of the results of my study were published by Brookings last month in a book, The Plight of the Thrift Institutions. My testimony today will draw on the material contained in the book, as well as on additional research conducted since the book went to press.

I would like to divide my testimony into three parts: the circumstances leading up to the situation we have today; the outlook for the thrift industry in 1982, 1983, and beyond; and my comments on H.R. 5568, the Home Mortgage Capital Stability Act, as a means of addressing the problems.

Background

Thrift institutions grew and prospered under a regulatory framework that led them to specialize in long-term fixed-rate mortgage lending and short-term deposit taking. The system functioned smoothly as long as interest rates remained steady. Deposit rate ceilings were imposed in the mid-1960s to restrain the cost of funds to institutions as market interest rates began to rise.

The thrift industry, despite periodic setbacks, gave the appearance of health during most of the 1970s. Assets of the more than 5,000 savings and loan associations and mutual savings banks tripled over the decade, exceeding $800 billion in 1980. The thrift institutions were the major source of new funds for housing during this period.

The ratio of net worth to assets of the thrift industry--a measure of long-term viability--fell continuously during the 1970s, however, indicating difficult times to follow. Deposit rates, which affect the cost of an institution's liabilities, were gradually becoming more sensitive to market changes as the result of administrative and legislative deregulation. The introduction of the six-month money

market certificate in mid-1978 is an important case in point. Rates of return on the asset portfolios of thrift institutions remained locked into earlier lower levels by the long-term nature of mortgages and by regulations limiting investment diversification. The authority to write variable-rate mortgages on a nationwide basis, for example, did not come about until several years after the liability side of the balance sheet was largely deregulated. When interest rates rose to record levels in 1980 and 1981, deposit flows and mortgage lending slowed, the cost of funds rose sharply, and profits turned negative.

During 1981, the savings and loan associations lost $4.9 billion, their first loss in recent history. The mutual savings banks lost $1.5 billion last year following a smaller loss in 1980. Net worth declined sharply and the thrift industry began sliding toward insolvency. Last month, the savings and loan industry's net worth fell below 4 percent of assets.

It should be stressed that this trend is a long-term problem of profitability and viability, and does not affect the routine operation of individual firms. Customers will continue to receive normal deposit and lending services throughout the period of adjustment. Liquidity--the availability of cash to meet normal business needs--has not been a problem for the thrift industry as a whole. Potential cash shortages have been avoided through a reduction in new lending and through increased borrowing. In the case of the savings and loan industry, most of that borrowing has come from the Federal Home Loan Bank System.

Outlook

As part of my research, I constructed a computer model to forecast the earnings and financial condition of the thrift industry. The results showed that structural changes will be required. A sizable minority of savings and loan associations will never return to profitability on their own, even under optimistic economic assumptions, and a much smaller number of mutual savings banks will be similarly affected. More than 400 firms--mostly small and inefficient, but with ample resources- must find merger partners to avoid potentially irreversible losses of net worth. Still others—at least 200, and possibly more than 600 under adverse economic conditions--may require financial assistance from the deposit insurance agencies to arrange mergers. A few closings and liquidations may occur.

In my book, I calculated the performance of the industry under three sets of assumptions, which I labelled "optimistic," "consensus," and "pessimistic." Under each set of assumptions, interest rates recede from their 1981 levels, the only difference being the speed of decline. I also incorporated fairly generous assumptions about mortgage turnover, sales of "all savers" certificates, and deposit growth. These were all based on expectations at the time my book went to press last fall.

Since the book was published a month ago, there has been much discussion over the validity of particular assumptions. It should be noted that the fundamental results remain the same regardless of the

assumptions; small differences in numbers of institutions affected and required assistance do not change the policy recommendations. I also want to point out that not only has the path of the economy followed the "pessimistic" scenario since my book went to press, but the industry has not fared well with respect to mortgages, certificates, or deposits either. To attempt to resolve this issue, I prepared a new set of forecasts for the savings and loan associations based on the Administration's relatively favorable interest rate assumptions as contained in the 1983 Budget. I have also used more current data on mortgage turnover, "all savers" certificates, and deposit growth. These results are compared in table 1 with the "pessimistic" forecast from my book.

As you can see, the industry as a whole does recover very rapidly next year under the Administration's assumed interest rates. Nevertheless, even more institutions--1,149 versus 1,076--are seen not to be viable over the long run, and the required costs of assistance are virtually unchanged at $6.5 billion. That is largely because the damage from regulation and high interest rates has already been done.

It should be apparent that the evolution of the industry over the next few years has been largely predetermined, and only the accounting rules that emphasize historical costs have prevented a widespread realization of this fact. Because of the losses which have already been incurred, many firms simply will not survive unassisted.

Table 1. Forecast of Income and Financial Condition, FSLIC-Insured Savings and Loan Associations

Indicator	Interest rate forecast: "Pessimistic" from Table 2-2a	Interest rate forecast: Administration Budget assumptions
Net income as share of average assets (percent)		
1980 (actual)	0.13	0.13
1981 (estimate)	-0.76	-0.76
1982	-0.53	-0.86
1983	-0.15	0.88
Industry assets, end of year (billions of dollars)		
1980 (actual)	609.8	609.8
1981 (actual)	644.7	644.7
1982	701.3	683.8
1983	761.9	740.4
Net worth as share of assets, end of year (percent)		
1980 (actual)	5.32	5.32
1981 (actual)	4.28	4.28
1982	3.45	3.01
1983	3.03	3.63
Associations viable only with merger, not requiring assistance		
Number of institutions	451	477
Percent of institutions	11.3	11.9
Total assets end of year 1980 (billions of dollars)	26.1	35.8
Associations not viable by 1983, requiring assistance		
Number of institutions	625	672
Percent of institutions	15.6	16.8
Total assets end of year 1980 (billions of dollars	83.4	68.5
Amount of assistance required (billions of dollars)	6.4	6.5

Source: Author's estimates based on FHLBB data. Data on assets and liabilities exclude loans in process.

a. Forecast data from The Plight of the Thrift Institutions, Table 2-2, page 30.

Policy criteria. The issues, as I see them, are as follows: first, to decide whether a consolidation of the thrift industry is desirable or avoidable, given the costs of preserving the existing structure; second, to decide what level of assistance to the housing industry is appropriate; and third, to select a set of programs to achieve the preferred outcomes. Whatever the ultimate decisions are, they must incorporate compensation--a subsidy--for thrift institutions or their insured depositors. So another consideration is who will pay for the accrued burden of losses, since the institutions cannot.

Required assistance to the thrift industry will be reflected in a significant impact on the budget, regardless of what policies are chosen. Assuming consolidation is encouraged to proceed, the net costs of assistance from the Federal Savings and Loan Insurance Corporation would exceed \$6 billion and the Federal Deposit Insurance Corporation would be called upon to supply over \$2 billion. These amounts include the expenditures exceeding \$1 billion by the FSLIC and \$700 million by the FDIC in 1981; the remainder would be paid out in some form over the next five to ten years.

Preservation of the industry with its current structure would necessitate large operating subsidies for the next few years and smaller infusions after that. The existence of many small firms does provide opportunities for local control and specialized attention to local needs. The drawback, however, is operating inefficiency. With increased homogenization of financial markets and institutions, and

with depositors becoming more aware of alternative uses for their savings, the specialized local thrift institution is less viable than in the past.

Cash flow. One potentially troubling factor that has only recently come to light is the increased flow of deposits out of thrift institutions. Last year, depositors withdrew nearly $40 billion more than they put into these institutions. In January of this year, another $138 million came out of savings and loan associations and $1 billion out of mutual savings banks, despite the availability of expanded IRA accounts and attractive deposit interest rates. Savings and loan associations reported a small net inflow for February, due primarily to a increase in jumbo certificates.

Deposit flows have fallen at times in the past, as individuals sought higher interest rates outside the regulated banking and thrift sector. The concern now is that people appear to be shifting money into commercial banks, sometimes accepting a lower interest rate to do so. After correcting for interest rate differentials and other relevant factors, the data indicate that one-third of the deposit outflows in the current episode represent shifts from thrifts to banks. The only plausible explanation is that some people now believe banks are safe and thrifts are not. The regulatory agencies call this the "quiet run."

The thrift industry cannot sustain this rate of losses indefinitely. Over the near term, the institutions can adapt by curtailing their new lending, leaving it to other sectors to provide funds for housing. Table 2 shows the historical and recent deposit flows for thrifts, banks, and money market mutual funds. (Note that these are gross flows, which include interest credited, and are thus not directly comparable with the net flows described in the preceding paragraphs.) Table 3 shows that the reduced deposit flows have been reflected in a reduced amount of new lending. Once the principal source of housing funds, the thrifts now trail commercial banks.

For the future, however, the "quiet run" poses two dangers: One is the possibility that it will turn into an all-out run on the thrift institutions. While I do not expect this to happen, such a run would create havoc in financial markets, demolish the hope of a stable monetary policy, and inflict serious damage on the national economy. The other concern is that the "quiet run" will continue, slowly draining the resources of the thrift industry. At the time I wrote my book, this did not appear to be likely, and I did not think any new policy was required. Now, with more data available, I feel that the liquidity problem is one that must be addressed.

Even if deposit inflows are restored however, the role of thrift institutions in the mortgage market will change. Housing finance will not be as abundant or as cheap as it was in the past, but the larger and more diversified thrift institutions that survive will continue as

Table 2. Growth in Consumer Deposits[a]

Net change from previous period in percent, annual rates

End of Period	Thrift Institutions	Commercial Banks	Money Market Mutual Funds
1975	16.8	12.2	n.m.
1976	15.7	15.6	n.m.
1977	14.1	10.3	11.8
1978	9.5	5.1	171.1
1979	5.2	9.1	323.3
1980	6.2	11.4	73.9
1981	2.8	16.3	144.0
1981 - I	3.8	31.9	262.9
1981 - II	3.5	11.3	110.9
1981 - III	0.4	11.4	158.9
1981 - IV	3.6	12.0	78.9
1982 - I (est.)	1.6	9.8	19.8

n.m. Not meaningful.

a. Savings deposits, time deposits under $100,000, retail repurchase agreements (beginning 1980), and other checkable deposits at depository institutions; quarterly data are seasonally adjusted. Balances in money market mutual fund accounts (institutional funds excluded beginning 1981).

Source: Federal Reserve, Statistical Release H.6.

Table 3. Sources of Mortgage Funds

Shares of net flows of new residential loans by type of institution, percent

Period	Thrift Institutions	Commercial Banks	Others
1975	65.5	1.0	33.5
1976	62.9	16.4	20.7
1977	56.1	18.7	25.2
1978	46.7	21.2	32.1
1979	36.3	17.4	46.3
1980	29.0	13.9	57.1
1981 - I	38.4	20.4	41.2
1981 - II	26.4	23.3	50.3
1981 - III	11.1	25.1	63.8
1981 - IV	-9.0	24.5	84.5

Note: Quarterly data are seasonally adjusted.

Source: Federal Reserve, Flow of Funds.

major sources of mortgage credit. Expertise in originating and servicing mortgage loans is a major asset of the thrift industry and one it is likely to exploit. New sources of lending and retail banking will move in to preserve service and competition if the thrifts fail to do so.

H.R. 5568 and Other Policies

The major issue is how to manage the transition. Left alone, most problem thrift institutions would arrange voluntary mergers; many would ultimately fail, requiring the deposit insurance agencies to pay off account holders. This process would take place over several years. At the discretion of the regulators, action could be taken sooner to arrange mergers or liquidations, and this could be less costly. The FSLIC has also begun a limited assistance program through the use of income capital certificates. Other policy instruments have been and will be used to prop up the industry, principally the "all savers" certificate and deposit rate ceilings. All of these plans share the common ingredient necessary for success: they include a subsidy to offset the losses incurred by failing institutions on their old low-rate mortgages.

This subsidy is not a "bailout," or at least not a new one. The decision to assist failing institutions was made when Congress created deposit insurance; economic circumstances then put the institutions in an untenable position. (Although the insurance applies to depositors, not institutions, it is usually cheaper and less disruptive to channel

the assistance through an institution. The law requires the FSLIC and FDIC to find the least costly alternative.) But the assistance plans are not equally efficient in solving the transition problems of the thrift industry. Some involve budgetary expenditures far greater than the amounts indicated above. Meeting the goal of efficient and effective policy will depend on supplying sufficient aid to the firms that require it and withholding it from those that do not.

H.R. 5568, the Home Mortgage Capital Stability Act, begins to address these issues. It contains many elements which, with the appropriate modifications, could go far to solve the transition problems of the thrift and housing sectors. In its specifics, however, the legislation would reward inefficiency, exceed cost estimates, harm the long-run viability of the housing finance system, and exacerbate the confidence crisis. Moreover, as drafted, it would not be completely effective in resolving the transition difficulties of the thrift industry: additional billions would still be required to aid hundreds of failing institutions.

Capital participation notes. The principal of injecting capital into ailing but viable institutions is a good one. The FSLIC is already using income capital certificates in a program to supply resources to institutions. Along with the assistance come stringent operating requirements. Such plans are intended to give an institution time to work out problems on its own, and to give the FSLIC time to arrange a merger should that become necessary. I understand that the

sponsors of H.R. 5568 intend to structure the capital program as an exchange of notes, which would result in no immediate budget impact; the cost of such assistance would be reflected in the interest payments to the savings and loan on the FSLIC's notes.

There are a few other technical changes that are required to assure that the capital maintenance program would be feasible, efficient, and effective:

(1) As designed, the capital participation notes would not be considered as increments to net worth. That is because of the requirement for ultimate repayment, regardless of earnings, which puts them in the category of debt rather than equity. So rather than increasing an institution's net worth, such notes would reduce it. Income capital certificates, on the other hand, require repayment only if and when the institution reports net operating income. The capital participation notes should therefore be designed along the lines of income capital certificates.

(2) There is an incentive for thrift institutions to sell low-yielding assets at a discount from par to reduce book value net worth, thereby qualifying for capital assistance. Such asset sales, however, may actually increase the association's market value net worth. The criteria for assistance should therefore be designed to exclude the effect of such transactions.

(3) Because the capital maintenance program is cut off when net worth rises to 3 percent, there is again a perverse incentive to make asset sales to incur losses.

Earnings stabilization payments. Some depository institutions may require a short-term subsidy to permit them to become viable over the long run. Where this assistance would be less costly than merger or liquidation, both in terms of direct outlays and social costs, it is highly advisable. The stabilization plan outlined in H.R. 5568 can be made operable if the following technical problems are addressed in the Committee's deliberations:

(1) The same perverse incentives to incur losses present with the capital participation notes exist with respect to the income assistance: Larger losses induce larger subsidies. On the contrary, banks and associations should be encouraged to reduce their losses.

(2) Although the plan calls for repayments to begin no later than five years after the assistance is rendered, many institutions may have no net after-tax income with which to make the required payments. This element must be modified in any case to structure the capital participation notes as capital rather than debt.

The best way to resolve these difficulties would be to set a market rate of interest on the agency obligations transferred to the problem institution, rather than to make the payments on the basis on losses. This would encourage reduction of expenses, sound investment decisions, and a rapid return to health. It would also prevent

open-ended subsidies to institutions which are not likely to survive, and which would thus be unable to repay the assistance.

Home Mortgage Capital Stability Fund. H.R. 5568, as introduced, envisioned the creation of a $7.5 billion fund at the Treasury to purchase the capital participation notes of institutions. Now that the legislation is to be modified, so that assistance would be provided with paper rather than cash, this fund is no longer required. However, in order to satisfy accounting standards and maintain credibility in financial markets, some backing for the notes of the agencies is still necessary. This could be provided through an increase in the agencies' borrowing authority at the Treasury; probably only the FSLIC would require an increase, as it has the largest obligations and only a $750 million line of credit.

Alternatively--and preferably--the obligations of the FSLIC, FDIC, and National Credit Union Administration could be made explicit obligations of the federal government. This would serve a dual purpose: it would provide the necessary financial backing for agency notes, and it would reassure depositors that their savings are indeed protected.

Savings, certificate, and transaction accounts at most depository institutions are insured up to $100,000 by the FSLIC or FDIC. The claims of other account holders and creditors, including those holding repurchase agreements, are subordinate to those of the insured depositors. In many institutions, the liabilities not covered by

insurance have been reduced or withdrawn for fear of default. Moreover, as noted above, even insured depositors are withdrawing their funds, as the resources of the insurance agencies are seen to be in doubt.

Title III of the National Housing Act (12 U.S.C. 1721), which pertains to the obligations of the Government National Mortgage Association, states, "The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty under this subsection." A similar provision, substituting the word "insurance" for "guaranty," could be added to Title IV of the same Act (12 U.S.C. 1726) which pertains to the duties of the FSLIC. It would also be advisable to make comparable amendments to the Banking Act of 1933 (12 U.S.C. 1811) which established the FDIC, and to the Federal Credit Union Act (12 U.S.C. 1781) which established the National Credit Union Administration and the National Credit Union Share Insurance Fund.

There would be no budgetary impact to either an extension of full faith and credit or to increased borrowing authority, unless and until expenditures were made. But since it is universally acknowledged that the insurance obligations would be met in any and all circumstances, there would certainly be no additional impact on the budget from either policy. Moreover, by reassuring depositors, liquidity would be improved, lessening the burden on the regulatory agencies.

Housing assistance. H.R. 5568 would require institutions receiving capital and earnings assistance to invest at least 50 percent of net new deposits in residential mortgages for first-time homebuyers at below-market rates. The thrift institutions' problems derive in large part from the preponderance of a single type of instrument in their asset portfolios—the long-term fixed-rate residential mortgage. Regulations and tax law precluded institutions from doing much else. The expanded asset powers permitted by the Depository Institutions Deregulation and Monetary Control Act of 1980 and those proposed in subsequent legislation are intended to reduce the balance sheet vulnerability of thrift institutions and to foster equality among financial institutions. The new powers are vital to the future health of thrifts that survive the current transition problems. Although expanded asset powers are not a panacea for today's ills, they should be considered now as part of a plan to revive and restructure the thrift industry, rather than forcing institutions to make unprofitable investments. Moreover, to the extent that new powers can reduce the costs of assistance, they will have a favorable impact on the budget. An overemphasis on long-term mortgage lending at low rates was directly responsible for the problems the industry faces today. Requiring thrift institutions to return to the ways of the past as the price of short-term assistance would be to perpetuate a bankrupt policy.

As a matter of choice, most thrift institutions will continue to invest at least 50 percent of net new deposits in mortgage loans in any event, but the rate and allocation requirements in the proposed legislation are unworkable. The bill sets a mortgage rate limited to one percentage point over the institution's average cost of funds. This average is composed of existing deposits, many in passbook and fixed-rate accounts, as well as the net new deposits received at much higher rates. But the new mortgages will have to be financed not out of the old funds at "average" rates, but out of the new deposits at the much higher "marginal" or market rates. The marginal cost of new deposits, as reflected in the rates on money market and small savers certificates, range from 13 to 14 percent. Savings and loan associations today have an average cost of funds of about 11.5 percent, implying that new mortgages would be written at 12.5 percent rather than the current 15 percent market rate for mortgage loans closed. Subtract one percentage point from the mortgage yield for the cost of servicing the mortgage, and the implication is that an institution would lose money on such transactions.

The institution would then have four options:

(1) It could refuse assistance in the first place, thereby avoiding the mortgage lending requirement but probably hastening its own demise.

(2) It could proceed with the transaction, knowing that the earnings stabilization payments under the Act would make up the losses. (The federal government would therefore be subsidizing these below-market mortgages indirectly.)

(3) It could write a variable-rate or graduated-payment mortgage, thereby assuring that the interest rate would eventually rise to market levels.

(4) It could recoup the difference between the subsidized rate on the mortgage and market interest rates by charging a higher fee (points) to originate the loan.

These alternatives demonstrate the difficulty in achieving social objectives through indirect means and internal subsidies. If Congress wishes to provide assistance to the housing industry or to homebuyers, it could be done more efficiently if done directly through the appropriations process. It is important to distinguish housing policy from the related, but narrower, task of rescuing the thrift industry.

Mergers. The principal means used so far to address the problems of the thrift industry has been merger. Many depository institutions have expressed a strong desire to extend their area of operation, including expansion across state lines which has traditionally been prohibited. Such market extensions provide profit opportunities and competitive advantages through economies of scale and scope. The FSLIC has approved a number of interstate mergers for troubled savings and loan associations. Approval of an interstate or cross-industry merger

may be likened to a license that can be offered for sale. In effect, the FSLIC is selling market entry rights for its own benefit. The price of the license is the excess of liabilities over assets for a failing thrift, a price that would have to be paid by the insurance agency if the license is not sold. (The merger approvals have often included a small amount of financial assistance from the FSLIC.) Even if H.R. 5568 were to pass, appropriately modified, the need for substantial numbers of mergers would not be eliminated. The bill, by its focus on institutions with "reasonable prospects for long-term viability," correctly does not seek to forestall the necessary process of consolidation. This policy, if properly executed, will reduce the administrative and financial burden on the agencies, thereby cutting budgetary expenditures as well.

Conclusion

The programs in place today will prove adequate only if there is a major improvement in economic conditions that retards the pace and reduces the level of thrift industry losses. The deposit insurance agencies will play a crucial role in any event. Net costs of assistance at $6.5 billion for the FSLIC and $2.1 billion for the FDIC are within the capabilities of the agencies. In the case of the FSLIC, however, the margin is slim, even though the costs will be spread over several years. The number and gross cost of the transactions could overwhelm the agency's administrative capabilities and impair its liquidity.

The most urgent change needed in current policy is an enhancement in the powers and resources of the FSLIC. (Although it will not likely require them, any changes affecting the FSLIC should apply to the FDIC as well.) Ideally, the agency, in concert with the executive branch and Congress, would develop a comprehensive program to subsidize, merge, or sell off those few hundred associations that are virtually certain to require assistance. This plan should be implemented rapidly, thereby ending the erosion of firms' assets, minimizing market uncertainty, and preserving public confidence in the agency's ability to protect depositors.

Arrangements should be made to bolster the agency's resources. Additional standby borrowing authority at the Treasury may be sufficient, but putting the full faith and credit of the federal government behind the obligations of the insurance agencies is preferable. Thus prepared, the restructuring of the financial sector can proceed with minimal disruption to markets, adequate protection for depositors, and the least cost.

Should it be decided that some form of broad subsidy is desirable, additional budgetary expenditures will be required. Such programs, however, must be justified on their own merits, as they are not necessary for protecting depositors, maintaining public confidence, or restoring the viability of the financial system.

Once the issue of nonviable thrift institutions is resolved, the question of the housing industry recurs. Some modest changes to relax credit market barriers, such as permitting more flexible mortgage instruments, are appropriate. Beyond that, economics has little to propose, the issue being one of social policy. Congress may decide that the equilibrium supply of housing is inadequate in an unregulated market and seek to shift the distribution of resources back into that sector. But the depressed condition of the housing industry today is due to interest rates and recession, and is more the cause than the result of the thrift industry's problems.

Thank you.

Mr. GONZALEZ. Thank you, Mr. Carron, for an excellent statement, and your willingness to come before the subcommittee and invest your time.

I obtained a copy of your book, thanks to Brookings' very generous policy toward the Congress. That makes it available upon request of an individual Congressman. I was thinking during this week when we had the regulators and others, because I was also aware of some of the dissents from some of your assumptions by some economists. But the testimony we were hearing earlier this week kind of bolstered your presentation, even though, as you said, the book had been written before some of these developments that agitate us now.

The question I have for you is: What is your opinion of the validity of the obvious motivation impelling the administration in its budgetary decision, since last year, that there is too much credit allocation now, nationally, to housing. I consider that to be the main problem because if you have that as a basic philosophic consideration, and you conclude it, as I think they have dogmatically, that there is a disproportionate allocation of credit to the housing sector.

And therefore, such things as phasing out the secondary mortgage institutional efforts would be deemed proper. I was very interested in knowing what your opinion is of that? Is it consistent with your studies of this very important aspect of the economy?

Mr. CARRON. Mr. Chairman, there are many features of the Tax Code, the laws of the country, and regulatory policy which create incentives or disincentives to make investments in certain areas. The deduction for home mortgage interest is one example. The fact that the implicit rent that one pays as a homeowner to oneself is not taxed, that is an element.

On the other side, in the industrial sector we have the investment tax credits, accelerated depreciation, and with the Economic Recovery Tax Act, the so-called leasing provisions. All of these seem to shift the balance in favor of one sector or another.

My feeling is that there is no one right mix. Over the past several years, there has definitely been a shift in emphasis away from housing and toward the industrial sector. With the prospect of growing budget deficits and the requirement for funds for the Government, there is also a shift away from housing and into the Government sector.

Now, these are to a large extent explicit decisions that are made with respect to budget policy, tax policy, and so forth. As I say, there is no one right mix. It is a question: You have to decide how much housing do you want in the economy versus how many factories, versus how many defense industries.

Chairman GONZALEZ. A national policy or political question, very good.

Mr. Kennedy, as you know, we are traveling on two rails on these hearings. Actually the chairman's bill is an emergency basis, because the Subcommittee on Housing and Community Development which is conducting these hearings has sort of a joint jurisdiction with the distinguished chairman's own subcommittee. We wanted to make sure we took advantage of the announced hearings we had planned for this subcommittee to entertain this bill.

But in light of the administration's statements, I think best illustrated by yesterday's report of President Reagan's address to the realtors, that he was categorically against anything that he calls a bailout. Am I correct in assuming from your statement that such a need is the case of your association and its evaluation of H.R. 5568, that it is by definition a bailout, even though it has been changed and modified, to lessen budgetary impact instead of your cash loan, guarantee of a loan.

Am I correct in that interpretation?

Mr. KENNEDY. Mr. Chairman, I share with Ms. Seibert the dislike for the word bailout in the first place. I think it is a poor description of what we are talking about with relation to the thrift industry.

Our concern with relation to this particular piece of legislation has to do first of all with where does all of this end. The assumption being that in this particular circumstance, this $7.5 billion would be the end-all and be-all. We are not sure that that is correct. But more importantly, we believe that the basic problem lies in resolving the deficit which is apparently in a runaway situation.

So far we have not been able to get the administration and Congress together to make a determination as to whether it is going to be resolved. The net effect is that we are living with high interest rates. The financial world and the banks of Arkansas do not perceive that we have gotten a full handle on inflation yet, and there is an inflation factor built into interest rates.

That is the basic problem that we have. We need to be addressing that particular problem. If we can overcome that the rest of the picture will fall back into place. I believe that is right. I think that would be the saving of the thrift industry.

Chairman GONZALEZ. I know in your statement that you said you agreed with the thrust of the legislature.

Mr. KENNEDY. We recognize the problem, yes, sir.

Chairman GONZALEZ. Mr. Wylie.

Mr. WYLIE. Thank you very much, Mr. Chairman.

I am glad to see you again, Mr. Kennedy.

Mr. KENNEDY. Thank you, sir.

Mr. WYLIE. I want to welcome you here, I think this is your first appearance before a congressional committee.

Mr. KENNEDY. I believe in the House, yes, sir.

Mr. WYLIE. Well, I certainly want to say that we feel privileged to have your first appearance in the House occur before our Housing Subcommittee.

I want to thank you for an excellent statement. Since you did not agree with the way the problem of the thrift institutions would be handled by H.R. 5568, do you have any suggestions as to what this committee might do to help solve the problems of the thrift institutions?

Mr. KENNEDY. We do not have any specific suggestion other than the one that I just mentioned. I might add that if you proceeded with H.R. 5568, as I indicated in my testimony, I think that it ought to be amended to take care of the charge for real estate loans to be made at 1 percent over the average cost of funds, because, as Mr. Carron just testified and we testified also, you have protracted difficulties that would ensue there.

Our basic feeling about this, Mr. Wylie, is that we need to get on with the business of getting our budgetary problems squared away and then, when that happens, the perception will change and we think that the interest rate picture will then come down appreciably. That will resolve our problems.

We realize that needs to be done fairly quick, because there is an immediate problem. The other side of the coin is—I come from a farming territory. We have got difficulties out there with our farming community now. I am afraid if we fool around with that too long, you are going to be looking not only at the housing industry up here asking for additional help, but you are going to be looking at farmers as well. Maybe they are already up here, I just do not know it.

But the press is going to be there for help in all sectors of our economy. When you do this you are adding to the inflation problem. Inflation is a basic evil. I might say it took us 15, or 16, or 20 years to get into this problem. It is awfully difficult to get out of it in a hurry.

Right now with the Fed tightening down on monetary growth, the need is to get the deficit in hand, at least on some basis where people perceive it to be under control. That is really the thing that we need to do to solve this problem, and a whole lot of other ones.

Mr. WYLIE. I think that we all agree. Am I stating your position correctly, Mr. Carron, that the regulated financial institutions, and I use the word regulated advisedly, do not really have a problem which cannot be solved or can be solved, I should say, by lower interest rates. It cannot be solved by lowering debts. I did not feel that coming through in your testimony, necessarily.

But would that be your position, too? I think you took a little bit more pessimistic attitude about this short-term, vis-a-vis interest rates and suggested that other things had to happen to get the thrift institutions through this transition period.

But would you agree that the regulated financial institutions would be all right, or their problems would be solved, if we were able to bring interest rates down?

Mr. CARRON. That is undeniably true. Unfortunately, interest rates would have to get down below 10 percent and stay at that level for the rest of this year, next year, and the year after.

Mr. WYLIE. Why do you say 10 percent?

Mr. ST GERMAIN. How soon? How soon should they come down to 10 percent?

Mr. CARRON. Last year. Within the range of interest rates over the next couple of years that appears likely, I think additional programs to help regulated depository institutions will be required.

As part of my prepared statement I ran a forecast based upon the administration's interest rate assumptions, which do assume a sharp fall in interest rates for the end of this year. Even so you would have hundreds and hundreds of institutions that are not viable, because the damage was done in 1980, 1981, the first months of 1982. Lower interest rates would not help a lot of those institutions.

Mr. WYLIE. Do you think we need to be concerned about the fact that, as you predict, a lot of thrift institutions and savings banks might go by the wayside?

Mr. CARRON. I think as long as the process is handled in the correct manner, which is an orderly process of assistance or consolidation, whichever may be appropriate, I do not think there is cause for concern. The traditional barriers between segments of the market, between banks and thrifts and stock brokerage firms and mortgage bankers and so forth down the line, those barriers are now coming down. The institutions are branching out into areas that were formerly the preserve of a particular type of institution.

Therefore, it is no longer the case that savings and loans compete only against savings and loans. They now compete against commercial banks, Sears Roebuck, Merrill Lynch, American Express, National Steel, and we could go on and on.

Mr. WYLIE. Should we allow that to happen? Should we allow the commercial enterprises to become as involved in the banking field as they are, through such firms as Sears, Merrill Lynch, and American Express?

Back in 1933, we concluded that banking should be separated from commerce, so we did not allow a bank to participate in any activity which was not bank related.

On the other side of the coin, consider the commercial enterprises, such as Sears, and other large financial institutions. By the year 2000, it has been predicted, and Sears may have interstate branches in every one of the Allstate stores. Should we stand by and allow that to happen? Or should we say that we do not think that is the best interest of the financial institutions? Should we try to regulate the banking activities of nondepository enterprises?

Mr. CARRON. To some extent, this process has already begun. There are good ways and bad ways of allowing it to proceed. On one extreme, you might have the banking operation conducted by the same corporate entity as is engaged in some other line of business. And then when you have the stability of the financial system

involved, deposit insurance involved, that could set up a very improper situation.

On the other extreme, you might have two companies, one a financial institution, the other not, under the same holding company, under the same umbrella, where all of the banking activities would be kept separate and subject to all of the stringent regulations that do apply.

I think that somewhere in there is the possibility for allowing new sources of capital into the financial industry, new types of services that might be brought in, new types of innovations that will benefit both borrowers and savers.

Mr. WYLIE. Mr. Kennedy, what do you think of the action of the Depository Institutions Deregulation Committee on March 22 to establish an instrument of $7,500 with a rate differential as a move toward deregulation?

Mr. ST GERMAIN. He is terribly excited about it, happy.

Mr. WYLIE. Do you want to bet?

Mr. KENNEDY. Well, I do not think much of it. We objected to that for two primary reasons. One, we want them to give us something that will let us be competitive with the money market funds. That instrument is not competitive with money market funds, the rates are too low.

Mr. WYLIE. Because it is tied to the T bill?

Mr. KENNEDY. Yes.

Two, it put the differential in there which we strenuously object to. We feel like the time has come when the DIDC committee ought to do what they were set up to do which was to deregulate, in our judgment.

Mr. WYLIE. At the same time they did it, they set up a schedule for deregulation.

Mr. KENNEDY. I appreciate that. I just hope they keep it on there.

Mr. WYLIE. You do not think that was a fair trade-off, though?

Mr. KENNEDY. Not quite, no, sir. Because we and the thrift industry are losing—well, you know as well as I do, that the money market mutual funds have about $190 billion. That comes in great part out of the hinderlands of the country and moves to the big city banks in foreign dollars and Canadian dollars.

I think it is bad for the country.

Mr. WYLIE. Mr. Carron says that most of the money going out of the thrift institutions now is going into commercial banks. We have some indication there, and perhaps someone suggested to FDIC the other day, that a new instrument may be a way for them to compete with the commercial banks.

We did try to help both the thrift institutions and the commercial banks by passing a resolution saying that the full faith and credit of the United States of America is behind this funding, and I thought it probably was.

If it wasn't, then we have become overexposed, and maybe this $6 billion from the FSLIC wouldn't be sufficient. I understand that you do approve of that action.

If the thrifts were deregulated, what will be the effect on the viability of mortgages? Formerly, about 50 percent of all of the mort-

gage money came from thrift institutions, but now it is down to about 8 percent. Do you suspect some serious difficulty?

Mr. KENNEDY. You can get varying opinions on that, depending on whether you are talking to realtors or homebuilders. They don't like that thought. Our judgment is the money will be there if the rate is right. If you let the marketplace work, we will have money to lend for housing or whatever, but it is not going to be there if it stays tied up in regulations that won't let us do it.

I was delighted to see that the President the other day recommended steps for pension funds to increase their eligibility for residential mortgage lending.

Mr. WYLIE. Thank you for an excellent statement.

Thank you, Mr. Chairman.

Chairman. GONZALEZ. Thank you.

Mr. Chairman?

Mr. ST GERMAIN. You just said the money will be there if the rates are right.

Mr. KENNEDY. Yes, sir.

Mr. ST GERMAIN. If that is the case, why was the Home Loan Bank Board created in the first place? Weren't the rates right back in the thirties and forties?

Mr. KENNEDY. I am happy to say I don't go quite that far back, doggone near it, but not quite. The commercial banking industry—my recollection of it at that time, I was not involved—was reluctant to make term loans.

Mr. ST GERMAIN. They made 5-year loans, very short-term loans?

Mr. KENNEDY. Yes, sir.

Mr. ST GERMAIN. The 20- to 30-year mortgage was unheard of?

Mr. KENNEDY. Yes, but at the time we didn't have the sophistication we do in variable rate loans. I think you will find a different set of thinking with some of the innovative ideas that have taken palce.

Mr. ST GERMAIN. But they had balloons then, the same thing.

Mr. KENNEDY. Sure, but I expect you find some residential loans——

Mr. ST GERMAIN. The point is, Mr. Kennedy, the Home Loan Bank Board and the thrift industry were created because there was a vacuum. The thrift industry wouldn't have grown as it did absent a need.

Mr. KENNEDY. I understand that.

Mr. ST GERMAIN. A need.

Mr. KENNEDY. I understand.

Mr. ST GERMAIN. That is why Mr. Carron makes a declaratory statement on page 19 that as a matter of choice thrift institutions will continue to invest at least 50 percent of net due deposits in mortgage loans in any event.

On what do you base that statement, Mr. Carron? I mean, do you have a crystal ball that I have not been able to find?

Mr. CARRON. There is the provision of the tax code, the bad debt deduction, which requires that 82 percent of the S. & L.'s portfolio be invested in qualifying assets.

Mr. ST GERMAIN. I saw the ticker tape today or within the last 2 days, with a listing of institutions, corporations and their profits, and among those they had the amount of taxes they pay.

Could you tell me that the merging plants don't have as good a tax advantage as the thrifts do?

Mr. CARRON. Commercial banks have more tax advantages.

Mr. ST GERMAIN. There you go, so don't tell me about the tax advantage. If you allow thrift people to do this, they will have the same tax advantage, so that will blow that one out of the wall.

What is your next one?

Mr. CARRON. I think what I am suggesting, Mr. Chairman, is that there are profits to be made in mortgage lending. The institutions that are making mortgage loans today are making a lot of money on those loans.

Mr. ST GERMAIN. Are there profits to be made in mortgage lending? That has been true over the past 50 years, is that right, up until this last period?

Mr. CARRON. That is right.

Mr. ST GERMAIN. With the high interest rates?

Mr. CARRON. That is correct.

Mr. ST GERMAIN. That being the case, how come commercial banks won't enter the field?

Mr. CARRON. The thrift industry——

Mr. ST GERMAIN. Because the profits in commercial lending, short-term lending, corporate lending are higher. I mean, let's just call a spade a spade.

Mr. CARRON. Mr. Chairman, the savings and loan industry was established to be the specialized mortgage lender.

Mr. ST GERMAIN. And why? There was a need.

Mr. CARRON. Absolutely. The Home Loan Bank Board, the FHA, these served a role, a sort of demonstration role, saying that long-term mortgage lending was safe, good for the country and served a very useful purpose in this country.

I just want to make one point here.

Mr. ST GERMAIN. I will get back to you, Mr. Kennedy.

Mr. CARRON. Notwithstanding the fact that because of tradition, habit——

Mr. ST GERMAIN. They didn't cut our pay.

Mr. CARRON [continuing]. Tradition, habit, tax law and regulation, the thrifts, the S. & L.'s, particularly, were intended to be the primary mortgage lenders. If you look at the most recent experience, when times get tough, when you really want to rely on the specialized mortgage lenders to stay in there, who were the first ones to drop out? The thrifts.

In table 3 on page 11 of my prepared statement you can look at the experience. In 1977, which we can take as the starting point of this episode, thrift institutions supplied 56 percent of the mortgage funds, commercial banks 19 percent. I will skip over the more recent period. The third quarter of 1981: thrifts, 11 percent; commercial banks, 25 percent; fourth quarter of 1981, thrifts minus 9 percent, commercial banks 25 percent.

So, what I am saying is——

Mr. ST GERMAIN. That doesn't mean that commercial banks made more mortgages than they made previously. You are talking about the percentage of all mortgages that were made?

Mr. CARRON. That is correct. They are making more mortgages. Their share of the mortgages outstanding has continued to in-

crease, even though the amount of net new lending has fallen off, the total stock in mortgages in the country——

Mr. St Germain. I thought that 25 percent of 100 is less than 19 percent of 1,000.

Mr. Carron. I am not sure I follow you.

Mr. St Germain. If you have 1,000 mortgages being made and you make 19 percent of them, that is even more than 25 percent of 100 mortgages, isn't it?

Mr. Carron. That is certainly true.

Mr. St Germain. So what I am saying is that the amount, the number of mortgages that were made in this period where you cite the 25 percent and the minus 9, sir, the number of mortgages plummeted.

So you know charts, graphs, you can play all kinds of games with them. It depends what conclusion you want to come to. You have to look at what stands behind it.

Now let's get back to my original question. On what do you base your statement that thrifts would remain and continue to make 50 percent or more or invest 50 percent or more of their new deposits in mortgage lending?

Mr. Carron. Because that is where they will make the greatest profits. Even during——

Mr. St Germain. You feel that they make a greater profit in mortgage lending, or will make one, than they may be able to make in commercial lending?

Mr. Carron. Absolutely. If you were to say that they should——

Mr. St Germain. Let me ask Mr. Kennedy.

Mr. Kennedy, do you make a larger profit in mortgage lending than commercial?

Mr. Kennedy. I have never looked at it exactly like that, sir. Let me qualify my statement to this extent. About 30 percent of my loan portfolio is in long-term real estate. I wish it wasn't, but it is.

Mr. St Germain. But you are an unusual institute. How large a community are you from?

Mr. Kennedy. Sixty thousand, a bank of $160 million. I am a community bank.

Mr. St Germain. As I stated earlier, I fully appreciate and admire the fact that banks such as yours over the years, not only in the commercial lending but you have the farm community that you are servicing. You are an unusual species.

Seriously, I have a lot of admiration for you.

Mr. Kennedy. I don't feel that way about it. I am very much like the major portion of the banks of the United States.

Mr. St Germain. Of the small banks in the small communities.

Mr. Kennedy. I want to get back to something else. I may get myself in trouble doing this, but I wanted to touch on it for just a second.

You made the statement, I believe, that commercial banks didn't make mortgage loans over the years, going back to the thirties, because commercial loans were more profitable.

That may be true to some extent, but the primary thing we need to remember is that the commercial banks that lived through the Depression and were formed out of it were operated by bankers

who learned the hard way that long-term loans were not a good thing to have on your books.

If I had learned that lesson at that particular point in time, I might not have done what I did. That was the basic reason that you couldn't get real estate lending. It was a good credit judgment. It wasn't really a good social judgment.

Mr. ST GERMAIN. I think we are saying the same thing.

Mr. KENNEDY. I wouldn't be surprised. I would be happy to agree with you, sir.

Mr. ST GERMAIN. Mr. Kennedy, you said to Chairman Gonzalez that the basic problem is to resolve the deficit and therefore high interest rates.

Let me ask you this: I know you are much younger than I, but you were in the service at some point. Did you serve in the Navy or Air Force?

Mr. KENNEDY. The Marine Corps.

Mr. ST GERMAIN. Did you go on some ships at some point in time, take a little trip overseas?

Mr. KENNEDY. Sure did.

Mr. ST GERMAIN. Were there lifeboats and lifejackets on those ships?

Mr. KENNEDY. Absolutely. Fortunately I didn't have to use one.

Mr. ST GERMAIN. Exactly. You didn't have to use them. You didn't encounter enemy action, nor were you struck by a hurricane or a severe storm that might batter the ship to the extent that you have to abandon ship.

Well, now, would you say that the basic problem is resolving the deficit and high interest rates; that is, the ship that is going on calm waters with no enemy action?

It is like the condominium or the big hotel that you build now, where you spend a great amount of money with fire alarms, smoke alarms, and fire prevention and for the sprinkler systems and the prevention of fire and you hope to God you will never have to use any of those, but you do make an expenditure for those, as you do for the lifeboats and the lifejackets on the ship and for the saving ships on a plane.

We are not in calm waters right now. The thrift industry is in one whale of a storm. The reason I introduced this legislation is that until such time as the waters subside or that we know that there is not going to be a fire or an enemy attack, I think it is good to have those safety precautions.

We need those lifeboats right now for the thrifts. They could be saved.

Incidentally, when I read your testimony, although it seems adverse, nonetheless it is not as adverse as it might have been because I think that in the bottom of your heart you and those who work with you on this realize that these thrifts do need assistance.

The only thing that disappoints me is the fact that you didn't recognize that which I have been saying for a month now; that is, that we have pulled off the $7.5 billion that would affect the deficit, and instead what we are saying is that we will use net worth guarantee certificates with an appropriation but not an outlay.

My concern is taking care of the deficit and my recognition of the fact that we are all concerned about that.

Now, if we in our hearts believe that Reaganomics is going to work and that interest rates are going to go down, because Mr. Reagan and the Secretary of the Treasury yesterday told me he anticipates a drop of 3 or 4 points, that will serve to alleviate the situation.

Now, how can the administration and those who support Reaganomics say well, this would be a costly program when, indeed, we all are looking forward to the fact that interest rates are going to come down. If the interest rates come down, the problems that these institutions that would receive the net worth guarantee certificates, the problem they are facing will be alleviated, just as you said.

The basic problem is the result of the deficit, bringing the interest rates down. You never have to cash one of those in.

Now you had other suggestions in here that certainly we understand and will take cognizance of on certain factors. I think one was that we allow an institution to have the guarantee for the certificate for 2 years, but that the program itself, you feel, should have a sunset.

Did I read that correctly?

Mr. KENNEDY. Yes.

Mr. ST GERMAIN. The reason for these hearings is to, again, garner as much constructive criticism as is possible. You sat through our first panel and heard what we said. We are looking for assistance. We want to improve it.

In reality, Mr. Kennedy, don't you think there are thrifts out there that need assistance and if they were given this kind of assistance could weather that storm through the time it takes us to get lower interest rates?

Mr. KENNEDY. First, let me say anybody who says the Congress of the United States doesn't work hard is going to have to speak to me after I have been up here. I have got to go catch a plane in just 1 minute, but I appreciate your deep interest in the problem. We share it, and we have a great deal of sympathy for the present situation.

I continue to believe that the way out of it is control of the deficit situation. I want to make it clear, we are not against some form of capital assistance provided you put it on a basis where you could clearly assess its cost, which is in terms of our priorities, that you give some discretion—and you all discussed that earlier—with relation to who is a bad manager and ought to go because they are bad managers. This is a difficult area, but it needs to be addressed.

Mr. ST GERMAIN. When we had the regulators here, Mr. Kennedy, we asked them to give us what they would like to see in statutory language. They didn't want entire discretion. They wanted some guidelines. We want to give them that. If you and your organization could provide some thoughts, we would appreciate it.

What I guess I am saying is that I would like to see us work together on something like this. I know a lot of members of your organization. Some of the larger commercials and holding companies in the Massachusetts area, Rhode Island area, have expressed to me, chief executive officers have expressed to me that yes, indeed, we should do something.

I feel you are probably concerned as well. I would like to see us work together on this.

Mr. KENNEDY. We will be happy to work with you. We appreciate being invited to.

I have one other thought I would like to leave with you. It gets back to one point over the average rate, because that will create some problems down the road if we don't address that issue.

Mr. ST GERMAIN. We are recognizing that because I don't think we have had a witness who hasn't pointed out the difficulty there. Again, there will have to be a revision, but it was a first attempt. Incidentally, it took a long time to construct initially, but at least now we are getting a lot of input and a lot of participation. I couldn't agree with you more, obviously, that is an area that should be taken care of.

You do have a plane to catch. I have a few more questions of Mr. Carron. If there are no other questions of Mr. Kennedy?

Mr. WYLIE. I just wanted to comment, Mr. Chairman, that I have talked to Mr. Kennedy about this, and he feels thrift institutions do need some help and is willing to try to be of assistance on the problem.

On page 5, Mr. Kennedy, you state that since the greatest competition faced by depository institutions is from money market funds, depository institutions must have some way of gaining back the funds drawn away by this competitor. Then you state your proposal to lower the $25,000 minimum not subject to rate ceilings?

Would you object to permitting thrift institutions to compete for the same business?

Mr. KENNEDY. No, sir, we would expect thrift institutions would be competitive with us in that respect.

Mr. WYLIE. Thank you very much, Mr. Chairman. I have another question for Mr. Carron, but I will pursue it later.

Chairman GONZALEZ. We will release Mr. Kennedy. Just one question. Maybe you can comment on it for the record; that is, it is not directly connected with this.

What is your opinion of this bank franchising movement?

Mr. KENNEDY. Oh, out in the West?

Chairman GONZALEZ. Out in the wild West.

Mr. KENNEDY. That is where things like that usually start. It is an interesting development. I was in Phoenix at one of our meetings this week. There was quite a bit of controversy about it.

As long as they stay within the framework of the law and regulation, I don't see anything wrong with it at all because what they are proposing to do is to is to provide the services to banks. If I want to go out there and form a bank, they will franchise me to do business.

I think it is like what McDonald's and a lot of other people are doing as far as I am concerned.

Chairman GONZALEZ. If you got serious, why not get McDonald's?

Mr. KENNEDY. Might be too much competition, Mr. Congressman. I am not sure.

Chairman GONZALEZ. That is all.

Mr. ST GERMAIN. Thank you, Mr. Kennedy.

Mr. KENNEDY. It was nice to be with you. Thank you so much.

Mr. ST GERMAIN. You have been in good company this afternoon.

Mr. KENNEDY. I certainly have. I have been here a long time, too.

Chairman GONZALEZ. We want to thank you for your patience. Mr. Carron, we are very grateful for your patience.

We will recognize Chairman St Germain.

Mr. ST GERMAIN. Mr. Chairman, on page 22 you state that arrangements should be made to bolster the agencies resources. Additional standby borrowing authority at the Treasury may be sufficient, but putting the full faith and credit of the Federal Government behind the obligation of the insuring agencies is preferable. Thus, the restructured financial sector could proceed with minimal disruption to the markets, with adequate protection at the least cost.

The FSLIC and FDIC were created for one basic purpose: To protect deposits up to $100,000 now, originally $5,000 and then up to $10,000. Since I have been here it has gone up and up and up.

But as I say, that is their function. Their function is not to protect the jumbo CD holder, the sophisticated investor who determines that he or she are going to have an amount in excess of $100,000.

Let's face it. In many of the mergers the reason the merger has been affectuated rather than just shutting them down and liquidating has been to hopefully minimize the cost of the fund. Parenthetically, I wonder sometimes about minimizing of cost, when I look at the legal fees.

Sometime if you would like to make a nice study, enjoyable study, take a look at the fees that are paid to attorneys, appraisers and what have you in a case like USNB of San Diego. It is an ongoing thing.

But I think they are getting more out of what is being recouped than those people left hanging, hoping that there might be a little something left over for them, the stockholders and creditors. The basic purpose, as I repeat, is not to affectuate mergers but to protect deposits.

Now, if you give them carte blanche, like you suggest here, which is far beyond $7.5 billion, where does it stop? You talk about a costly proposition. What did Muriel Siebert tell us today? On one of the mergers had there been a liquidation it would have been $1 billion. They were able to bring it down to $500 million for the merger.

It doesn't take many of those $1 billion deals and the existing fund is gone. Then it becomes very costly. So, I don't think I can agree with you on full faith and credit to these agencies, not for the coverage of deposits, but to perform their functions, or perform the functions they have come to enjoy performing—merging.

Mr. CARMAN. I hope that it is clear that what I am suggesting here is not full insurance of accounts. The insurance of accounts and protection of accounts would still be limited to the $100,000. But should it ever become necessary in order to protect those accounts to go beyond the resources that the agency has today, then there would be a claim.

Mr. ST GERMAIN. How are you talking about protecting the accounts, sir?

Mr. CARMAN. That goes to the second point, which I think is a substantive issue because clearly the FSLIC was not created to pre-

side over a restructuring of the industry. It was designed to handle the random ill-managed institution that got itself into trouble, and to provide a supervisory role.

Mr. ST GERMAIN. Wait 1 minute. I have to take issue with you there. It is supposed to see to it that that institution isn't ill-managed and gets itself into trouble. That is why they have the examinations on a regular basis.

Mr. CARMAN. That is right. Now we have underway what I would call a secular shift rather than a cyclical shift. It is not the sort of thing where eventually you return to where you started from.

We are living in a new world now, and because of the way the laws pertaining to the FSLIC and the FDIC were drafted, those organizations were really in the front lines of this, though not by design.

However, there is no other agency out there. I suppose it would have been preferable had we all foreseen that this possibility might arise and constructed an appropriate mechanism and made all these decisions in advance about what the policy should be. I am not sure there is time today to do that.

With the regulator's bill you have gone some distance in doing that, in providing guidelines and framework for doing that. That is one way to go, but again, that still leaves the burden on the FSLIC.

So, I am not sure that you completely resolved that particular issue. Frankly, I don't think the FSLIC is perfect, but at the moment I think it is the best we have got.

Mr. ST GERMAIN. That is what Churchill said, right? Democracy is terrible but until a better form of government comes along, it is the best we have. Right now all we have is the FSLIC and FDIC. Without them, the fires would rage.

Mr. CARMAN. I agree. Now there are some who oppose the extension of full faith and credit.

Mr. ST GERMAIN. For what purpose, sir?

Mr. CARMAN. For the purpose of protecting depositors on the grounds that you indicated a moment ago; namely, that if they had seemingly infinite resources, they would then be less diligent in seeking the least cost alternative in dealing with problem institutions.

Mr. ST GERMAIN. That is not the problem. That is not the problem. The problem is that their function is to protect depositors up to $100,000, not those that I mentioned before, that are way beyond that. But that is what they would be doing in most instances.

Mr. CARMAN. That is right.

Mr. ST GERMAIN. How many liquidations have there been?

Mr. CARMAN. Only one.

Mr. ST GERMAIN. Economy. Then let's look at FDIC. The *Texas* case goes back. Back in 1971 or 1972 we had the *Texas* case, what was the Texas liquidation. Was it Sharpstown? Did you look at Sharpstown?

Mr. CARMAN. That was a bank.

Mr. ST GERMAIN. Absolutely. What I am saying is FDIC allowed Sharpstown to close but they do not liquidate banks of any size.

Mr. CARMAN. They liquidate——

Mr. ST GERMAIN. Yes, more than FSLIC, but still few and far between. Do you know what the real reason is? The minute they

allow too many liquidations, then they know full well that jumbos are going to come out of some institutions.

But to date investors have left those funds beyond the $100,000 in institutions feeling, well, we won't realize losses because they will find a merger partner if things get all that bad.

Mr. CARMAN. That is right.

Mr. ST GERMAIN. So in a way they are going beyond their original commission.

Mr. CARMAN. Let me suggest to you one alternative way of viewing this issue. I am not sure which is the correct one, but it is one point of view that I have heard; that is, that there is a bargaining situation when you hav a problem institution between the uninsured depositors and creditors on the one hand and the insurance agency on the other hand.

The question is, will these uninsured depositors and creditors be protected or not, knowing full well that they do not have the insurance protection in the law? If the agency has unlimited equity so that it could liquidate that institution and pay off only the insured depositors, that puts the agency in a much stronger bargaining position with respect to the uninsured creditors than if those uninsured creditors know that liquidation is not a viable option because of the financial constraints on the insurance agency.

They drive a very hard bargain to make sure they are protected in the merger because they know that merger is the only way out. So, if you put this larger resource behind the FSLIC, that puts FSLIC in a stronger bargaining position. It can carry through with a liquidation if it feels that the price being asked by the uninsured creditors is too high.

Now, as I say, I don't know. I am not privy to these discussions. But that is one story.

Mr. ST GERMAIN. School of thought, theory?

Mr. CARMAN. Yes.

Mr. ST GERMAIN. Tell you what. I am very grateful to you for your patience today, and Mr. Kennedy's and Mr. Harris. If you enjoy doing it, a little more information on your 50-percent theory would be helpful.

Incidentally, that is a little academic as far as the legislation is concerned because if they continue to invest 50 percent in new money in home mortgage financing, then what problem is there with having that requirement in the legislation, except for that which has been brought up, and that is the spread?

Mr. CARMAN. Well, there is also the fact that it must go to first-time home buyers and in an amount not to exceed the FHA limit. But I have no great problem with the 50 percent without the rate restrictions because historically they have invested that amount.

I really don't have strong objection to that. I think that there might be some paperwork burdens involved. Since I think they are going to do it anyway I say well, let's not have the paperwork. I don't have any trouble with the 50 percent.

Mr. ST GERMAIN. Thank you kindly, Mr. Carron. We appreciate it.

Chairman GONZALEZ. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman. I just have one question. Chairman St Germain tripped around this question. I want to get a little more specific, if I may.

Some witnesses have told this subcommittee that the main problem is how to avoid failures that would upset the existing system. Several have referred to a recent econometric forecasting system study that purports to demonstrate that mergers are far and away the most expensive way to deal with problem thrifts short of liquidation.

What is your evaluation of that study?

Mr. CARRON. I have not had the opportunity to analyze the Wharton study in detail. To a certain extent their assumptions are built into their calculations and are not visible for analysis.

Mr. WYLIE. Do you have an opinion as to the relative cost of mergers versus other solutions?

Mr. CARRON. I think that mergers should be undertaken when they are less costly than the alternatives. For a very large number of the associations that we talked about, the mergers are going to take place on a voluntary basis with no financial assistance.

The Wharton study assumes that all of these mergers would require financial assistance. Stepping back for a minute and looking at the array of policies which they review with costs ranging from zero to $120 billion or more, I would say that you don't get something for nothing.

There is a minimum cost involved here that is related to the losses that have been incurred in the past because of this portfolio mishap. That cost must be paid for.

I have estimated that cost at somewhere under $10 billion for the thrift industry as a whole. Most of that assistance would be provided in the form of merger, but in those cases where an ongoing assistance program is less costly, I would argue in favor of that.

You could restore the book value net worth of the entire industry, not merely that segment which is in trouble, for $80 billion. So, I think that that number as an expression of the costs of a particular program is entirely unrealistic.

Mr. WYLIE. May I say I am very impressed with your knowledge and the way you express yourself? If you want to take a close look at the Wharton study and give us your opinion, I certainly would be glad to have you supply that for the record.

Thank you very much, Mr. Chairman.

Chairman GONZALEZ. Thank you. I certainly join my colleague in that statement. We are very much impressed, very grateful to you for your time and your generous contribution. I hope we will have a continuing communication.

Mr. CARRON. Thank you.

Chairman GONZALEZ. Also, I would like the record to show that Mr. Phil Corwin, counsel for the Independent Bankers Association, has been dutifully and patiently here in the wings ready to answer questions we might have had. I had one, but I am going to submit it for the record.

[The following additional written questions were submitted by minority members to the witnesses and appear with the responses of the witnesses:]

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

April 6, 1982

Mr. Andrew S. Carron
c/o The Brookings Institution
1775 Massachusetts Avenue
Washington, D. C. 20036

Dear Mr. Carron:

Your recent testimony on H.R. 5568, the Home Mortgage Capital Stability Act, before the Subcommittee on Housing and Community Development has been received with great interest and studied closely by Minority Members and Committee staff.

Unfortunately, the limited amount of time available at the hearings did not permit as full a discussion of the issues as we would have liked. However, the Minority staff has developed a series of questions designed to give the witnesses a fuller opportunity to present their views for the record.

It would be very helpful, therefore, if you would respond to the attached list of questions. In order to ensure that your answers will be included in the hearing record, they should be received no later than April 16.

Thank you for your cooperation.

Sincerely,

J. William Stanton

JWS:bfd

Attachment

Response of

Andrew S. Carron

to questions submitted by the

Subcommittee on Housing and Community Development

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

April 16, 1982

1. On page 5 you state, "The damage from regulation and high interest rates has already been done Then on page 9 you state, "Once the principal source of housing funds, the thrifts now trail commercial banks."

Do these statements suggest that it may be at the same time too late and not necessary to save the thrift industry in the name of housing finance?

The thrift industry served an important role in developing our modern housing finance system, providing long-term mortgages when no other institutions would do so. But now the system has matured. Many lenders are providing funds for housing without the regulatory requirements or tax incentives that led the thrifts to invest in mortgages. There is no longer a compelling need for specialized housing lenders. Moreover, with changing economic conditions and innovations in the financial marketplace, such specialization is not a viable option. As I stated on page 20 of my prepared testimony, "It is important to distinguish housing policy from the related, but narrower,

task of rescuing the thrift industry." That task, as I see it, is to protect depositors, maintain public confidence, and restore the viability of the financial system.

> 2. On page 12 you state, "The major issue is how to manage the transition. Left alone, most problem thrift institutions would arrange voluntary mergers; . . . . At the discretion of the regulators, action could be taken sooner to arrange mergers or liquidations and this could be less costly. . . All of the] plans share the common ingredient necessary for success: they include a subsidy to offset the losses incurred by failing institutions on their old low-rate mortgages
>
> Some witnesses have told the Subcommittee that the main problem was how to avoid mergers that would upset the existing system and some of them point to a recent Wharton Econometric Forecasting Associates study which purports to demonstrate that mergers are "far and away the most expensive way to deal with problem thrifts, short of liquidation. . . ."
>
> What is your evaluation of the Wharton study and, specifically, of the relative cost of mergers versus other solutions?
>
> What is your evaluation of the practicality of maintaining the present system without extensive mergers?

The Wharton study, prepared for the National Association of Mutual Savings Banks, stated that assisted mergers were a more costly means of resolving the short-run thrift problem than other measures that preserve existing firms intact. In particular, the study found that mortgage warehousing appeared to be the least costly method. But the Wharton analysis was based on unrealistic perceptions of how such assistance programs work.

Although most troubled thrift institutions can resolve their difficulties without government intervention, the authors of the Wharton study assumed that all would receive Federal assistance equivalent to the amounts that have actually been paid in only the most extreme cases of financial distress. Moreover, any tax savings or efficiency gains from merger are not counted. This process leads, in the Wharton scenario, to 769 thrift mergers costing the government $84 billion over the next three years.

But that is not how the program works in practice. Last year, 337 federally-insured thrifts were merged out of existence. Of these, roughly half were troubled institutions, yet only 30 required any Federal assistance, and the total net cost was under $2 billion. Even with the spate of supervisory mergers so far this year, most thrift acquisitions have not involved any Federal funding.

These amounts are consistent with my own research, published recently in The Plight of the Thrift Institutions. I found that an assistance policy relying primarily on mergers would have a total net cost of under $9 billion. Since this amount, paid out at the rate of $1 billion to $2 billion per year, would be sufficient to protect insured deposits and maintain the viability of the financial system, larger subsidies cannot be justified. As I stated in my book (page 32), "Avoiding a consolidation of the industry, preserving intact all of the troubled firms, would entail costs greater than [those] needed for assisted mergers. To restore the firms' net worth would require

capital infusions or operating subsidies totaling [up] to $11.5 billion, depending on the path of interest rates."

Federal warehousing of low-yield mortgages, cited by the authors of the Wharton study as the least costly alternative, would cost $40 billion over three years as envisioned in the Wharton paper. This is substantially more than the $7.5 billion annual cost estimated by the thrift trade associations when they proposed the mortgage warehousing program in March of this year.

It is certainly true that merger is not the remedy for every troubled thrift. Indeed, the regulatory agencies are required by law to consider all of the alternatives, including "open bank" assistance and liquidation, in selecting the means of resolving each case. These agencies also recognize that an institution whose balance sheet looks dismal by standard accounting criteria may have good prospects for long-run viability, and these firms can and should be nurtured back to health. But the facts of the current crisis show that the government's assisted merger policy has been and will continue to be the most cost-effective and least disruptive means of rescuing the majority of problem thrift institutions.

3. On page 15, you state that "Where [earnings stabilization] assistance would be less costly than merger or liquidation, both in terms of direct outlays and social costs, it is highly advisable."

In what percentage of instances would you estimate that earnings stabilization assistance would in fact prove to be the least expensive alternative?

As I stated in response to the previous question, most problem cases are resolved through mergers not involving government financial assistance. The assisted merger cases represent perhaps 20 to 25 percent of the troubled institutions. On that basis, earnings stabilization assistance alone--not as part of an eventual assisted merger--would be the least costly means for resolving less than 10 percent of the problem cases. I base this estimate on an analysis of the financial performance of the problem thrift institutions. Such earnings assistance is appropriate for institutions that would ultimately return to profitability, and thus be able to repay the assistance, but where accounting standards might compel a merger or liquidation during a difficult transition period.

> 4. On page 19 you list four options that an institution would have to avoid making unprofitable mortgages under the formula provided in H.R. 5568. Would there not be a fifth option, simply to avoid taking net new deposits an option which might not be difficult to implement given the competitive position of thrift institutions in many markets?

Refusing new deposits would be an option, but not an attractive one. Thrifts would be reluctant to inconvenience their existing customers by declining to meet their requirements.

> 5. On page 21 you state that, "appropriately modified," and "properly executed," "the bill, by its focus on institutions with 'reasonable prospects for long-term viability,' correctly does not seek to forestall the necessary process of consolidation."

> Will it not be difficult to achieve the necessary modifications and to administer the bill properly in the face of tremendous pressure to maintain the existing competitive and regulatory structure?

I recognize that there are many interests involved in the debates over thrift legislation, and that opinions differ on the appropriate course of action. However, it is beyond the scope of my expertise to evaluate the political factors which may shape such legislation. With regard to the implementation of such legislation, should it become law, I foresee great difficulty and the potential for protracted legal proceedings in arriving at an operational definition of "reasonable prospects for long-term viability."

> 6. In concluding your statement, you state, with respect to the future of the housing industry, "Economics has little to propose, the issue being one of social policy. Congress may decide that the equilibrium supply of housing is inadequate in an unregulated market and seek to shift the distribution of resources back into that sector. But the depressed condition of the housing industry today is due to interest rates and recession, and is more the cause than the result of the thrift industry's problems
> Assuming that a decision to reallocate resources in favor of housing cannot be done in a vacuum what would be the consequences of such a decision for other sectors of the economy and for prospects for growth of the economy as a whole?

To provide a framework for responding to this question, it is useful to postulate that the pool of resources for current consumption and investment is determined by overall fiscal and monetary policy.

Then the issue is the allocation of the given resources among competing uses, which will determine future growth and employment. If more funds go to housing, then fewer resources will be available elsewhere. The future supply-side implications of any allocation policy therefore, depend crucially on where these new resources for housing are drawn from. There are essentially three possibilities: private consumption, government spending, and business investment. Because much government spending goes for transfer programs, it bears a certain similarity to private consumption in its effect on the economy. (Of course, some forms of government spending, such as educational programs, may be considered "human capital" investment.) If the desired increase in housing can be accomplished through a reduction in private or government spending, there need be no adverse impact on business investment. Reduced budget deficits, either through lower spending or higher taxes, are the principal means of accomplishing this type of resource shift. Otherwise, housing production might come out of needed business investment, with adverse implications for future growth and productivity. Thus, prudent public policy would demand a reduction in the projected budget deficits as the means of making additional resources available for housing. In point of fact, lower deficits would work through market mechanisms (such as interest rates) to generate both housing and more business investment.

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

April 6, 1982

Mr. Lawrence E. Kreider
Executive Vice President - Economist
Conference of State Bank Supervisors
1015 - 18th Street, N. W., Suite 606
Washington, D. C. 20036

Dear Larry:

Your recent testimony on H.R. 5568, the Home Mortgage Capital Stability Act, before the Subcommittee on Housing and Community Development has been received with great interest and studied closely by Minority Members and Committee staff.

Unfortunately, the limited amount of time available at the hearings did not permit as full a discussion of the issues as we would have liked. However, the Minority staff has developed a series of questions designed to give the witnesses a fuller opportunity to present their views for the record.

It would be very helpful, therefore, if you would respond to the attached list of questions. In order to ensure that your answers will be included in the hearing record, they should be received no later than April 16.

Thank you for your cooperation.

Sincerely,

J. William Stanton

JWS:bfd

Attachment

95-255 0 - 82 - 25

CSBS

OFFICE OF THE EXECUTIVE VICE PRESIDENT-ECONOMIST

April 20, 1982

Honorable William Stanton
B 371-A
Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Stanton:

Enclosed are the responses of John E. Malarkey to the list of questions developed by the Minority staff following Jack's testimony on H.R. 5568 on behalf of CSBS.

We appreciate this opportunity to more fully present the views of CSBS for the record.

We at CSBS hope that you are well following surgery. You have our sincere best wishes for a speedy recovery.

It is always sad when a member of Congress we have come to know and respect must retire from public service, particularly when it is for reasons of health. CSBS has come to know you as an honest, fair, hard-working and open-minded member, who often brought insight into muddied waters. Your presence on the Banking Committee will be sorely missed.

As always, CSBS stands ready to be of assistance to you and your staff in whatever way we can.

Sincerely,

Lawrence E. Kreider

Lawrence E. Kreider
Executive Vice President -
Economist

LEK:drj

Enclosure

1015 EIGHTEENTH STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 296-2840

RESPONSE OF MR. JOHN E. MALARKEY

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

TO QUESTIONS SUBMITTED BY

THE HONORABLE J. WILLIAM STANTON

RE: H.R. 5568--THE HOME MORTGAGE CAPITAL STABILTIY ACT

Question 1.A. Would you acknowledge any possibility that under deregulation, the entry of New Competitors into the industry and the advent of interstate banking may operate to reduce concentration, particularly in local areas now dominated by one or two institutions?

Response: We at CSBS are firmly convinced that the public is best served by a decentralized financial institutions regulatory system that works and that the dual banking system, with its inherent checks and balances, supports both the need to provide competitive services and the need to maintain the jurisdictional responsibilities of state governments.

At the heart of the dual banking system is the longstanding and valuable American policy against undue concentration of control of financial resources. Congress traditionally has sought to allow local authority, both ownership and regulatory, over financial resources, recognizing that concentration and centralization go hand in hand and that an economy controlled centrally by government or powerful private bodies may create rather than resolve economic problems. The evils which attend concentration of ownership and regulation--burdensome regulation and market control by a small group of individuals or organizations--are the enemies of productivity and freedom.

Our current banking system is efficient. Moreover, it is sensitive to our long-range national economic needs in ways which no other system can match. Benefits which flow from it include: diversity of both size and type of institution; diversity of regulation; competition; flexibility; responsiveness; innovation, and community perspective.

These benefits flow from a system which provides an institution the freedom of conversion between state and federal chartering, and guarantees competition between state and federal institutions by assuring equality of corporate powers. The prevention of a Federal monopoly in regulation insures against unduly burdensome regulation and guarantees against undue influence being attained by any public or private interest group. At the same time, a creative tension is maintained between the systems of state and federal institutions which has led to innovation in legislation and regulation.

Dual banking insures that all geographic areas and all sectors of the economy will be served. It fosters competition, while allowing institutions and regulators the flexibility to take into account differences in the markets which they serve. Dual banking is a vital part of the system of state and federal checks and balances and the cornerstone of the American policy against undue concentration of financial resources. These fundamental principles

are embodied in the McFadden Act and the Douglas Amendment to the Bank Holding Company Act.

Increased concentration of the financial institution industry and increased centralization of governmental control over the industry and the economy, the directions in which the current chain of events is leading us, are to be more feared and abhorred than a one-time government infusion.

The whipsaw of the money cost/portfolio yield mismatch and competitors not subject to interest rate control has given rise to a trend, encouraged by the policies of federal regulatory agencies, of mergers and acquisitions which have clearly been a concentrating factor in the thrift industry.

The clear trend has been the acquisition of institutions, of potential competitors, by larger institutions interested in expanding their deposit bases. Arguably, de novo entry into local areas now dominated by one or two institutions might enhance competition. However, in reality, several factors dictate that that would rarely, if ever, be the case.

1. Local areas served by one or two institutions tend to see a very high degree of community service and enjoy a high level competition for deposits between institutions of different types. No one has ever effectively argued that any sector of our economy is not now adequately

served. Small businesses, by a four-to-one vote in a recent survey indicated they are best served by local institutions where they get more personalized attention and more sensitivity to their needs. Consumers are free to shop among a wide diversity of institutions for rates and services.

2. Local areas which are dominated by one or two institutions tend to be rural, often agrarian, and hold little interest for institutions not so oriented.

3. The experience in states moving toward more liberal branching has been that the limited available deposit base in smaller communities, coupled with the traditional customer relationships enjoyed there, makes _de novo_ branching into these communities a losing proposition, except where the institutions already in place have not been adequately serving their communities. The result has been a pattern of entry by acquisition, with no resultant increase in competition. In fact, institutions entering by acquisition will quite often seek to maintain, in some form, the identity of the institution acquired, to gain the good-will of the community.

4. The economics of banking argue that better services and cheaper pricing of services will not

result from a breakdown of local autonomy. It is viewed as "common knowledge" that economies of scale do not attach to the operations of financial institutions. Because big banks cannot offer a better deal than small banks, they must acquire the smaller banks; i.e., they cannot price them out of business. By acquiring more institutions and more customers, the big banks increase their profits, but not their profit margins. The consumer sees no benefit. In the long run, consumers would be left with fewer institutions among which to choose and would have to deal with local representatives of a distant institution. Local availability of money is threatened as the money center banks, seeking the best return, ignore community needs in favor of high yields.

We at CSBS believe that the dual banking system is worth preserving and any solution to current problems must be designed to have the least possible negative effect on this objective.

In the context of H.R. 5568 and similar legislation incorporating the "net worth guarantee" concept, this translocates into a clear preference for legislation to assist, on a one-time basis, well-managed but seriously troubled institutions whose troubled largely reflect interest rate extremes, as brought about

primarily by extremes in past federal monetary and fiscal policies. The increased concentration from current federal agency policies designed to meet thrift industry problems is a far less acceptable alternative.

Question 1B. What assurance is there that the assistance we are about to provide will indeed be a "one-time infusion" and that another adage will not apply, that "hard cases make bad law."

Response: President Reagan has undertaken an ambitious program to turn around the economy of this nation. We have already witnessed a remarkable reduction in the rate of inflation. Since a "net worth guarantee" program such as CSBS has endorsed gives rise only to a contingent liability and since we have the Administration's assurances that the state of the economy, including the current high interest rates, will be shortly improved, there is no reason to believe other than that the assistance will be a "one-time infusion."

Certainly, the Republican members of the Committee do not wish to cast doubt on the effectiveness of the Administration's economic policies.

Additionally, it is difficult to envision a worsening of the economy which would not have far greater cost than the program now being considered. This is particularly true when you consider that the current merger pattern is doing little more than spreading around the aggregate unprofitable portfolio holdings and postponing its impact on the industry as a whole and, thereby, on the insuring agencies.

Question 2A. How would you determine "that the management of the institution is committed to its survival"?

Response: One of the great benefits which flows from our decentralized banking system is its responsiveness and local perspective. The accessibility of bankers to their public and of regulators to bankers under their jurisdiction guarantees rapid, informed and appropriate reactions to problems and changing local needs. Local control over local resources guarantees the role of banks as community servants as well as businesses, and the role of regulators as advisors to assist banks to survive in the public interest, as well as enforcers of law and regulation.

The primary regulator is qualified, in most cases, by the day-to-day business of his office to make determinations such as one that the management of the institution is committed to its survival. It must be remembered that the institutions we are discussing are those subject to potential failure. Primary regulator involvement with these institutions is greatly heightened and a strong knowledge of the management of the institutions flows from the level of contact which must be maintained. In essence, the determination involves exactly the type of knowledge which the primary regulator has by virtue of the execution of the duties of his office.

Question 2B. Is it possible for any regulator to make these determinations objectively in the face of enormous political pressure and the threat of law suits on the part of disappointed applicants?

Response: Yes, regulators make these types of determinations objectively all of the time. Occasionally, of course, there are those who violate the public trust by succumbing to political pressure or threats, but this is true of public officials elected as well as appointed and federal as well as state. Even members of Congress have been known to succumb to pressures and enticements.

Question 2C. Granted that the state regulator is closer to the problem, is there not an argument to be made that the determination should be made by the federal regulator, on the ground that it can be more objective, since it will not be as subject to local pressure, and that the federal agency may be more responsible, since it is ultimately going to bear the cost of failure?

Response: Pressures differ on the local and national level, but they exist with equal force in their various forms at both levels. No valid argument can be made that the determination should be made by the federal regulator, on the ground that it can be more objective. Such arguments merely evidence the existence of unjustified prejudices.

CSBS has stated that an institution's eligibility should, in part, be determined "by requiring that the primary regulator determine the institution's long-term viability, determine that the institution would have to be closed within the next 12 months without such aid, but would live with it, determine that the institution's losses have been caused by governmental action rather than mismanagement and that management of the institution is committed to its survival."

CSBS supports implementing this approach by providing for initial review of viability under the criteria of the statute by the primary supervisor (state or federal), with right of appeal of a denial to the

insuring agency and with an override of the initial decision by a unanimous vote of the board. Such an approach would avoid adverse effects resulting from arbitrary action by either primary regulators or insuring agencies. It would involve those most familiar with the day-to-day regulation of the institution in the eligibility process and reduce the increased work load to which Chairman Pratt referred in his prepared statement of March 24 (page 18).

Question 3. Is it likely that the policies which you advocate will result in increasing risk and costs to the insuring agencies? If so, would the states be willing to contribute resources to underwrite the maintenance of the current dual banking system?

Response: It is highly unlikely that maintenance of state authority within the structure of the dual banking system would result in any increase in risk and costs to the insuring agencies. To the contrary, effective utilization of the expertise of the primary regulators, both state and federal, can be expected to result in a decrease of risk and cost.

It must be remembered that within our current system of bank regulation state supervisors work closely with the insuring agencies, not in a vacuum. The closing of institutions impacts at least as severely on state officials and often more so than on federal regulators. In determining the viability of an institution, working with less than the best available information is certainly a mistake where public funds are to be committed. The public interest is of paramount importance for regulators on both the federal and state levels, it is only the perception of the public interest that may differ. CSBS firmly believes that the element of risk will be greatly lessened by the utilization of the primary regulator in the determination of institutional viability.

The proper role of the government in the regulation of financial institutions has many aspects. Among the most important of these are the safety and soundness of institutions (one aspect of depositor security), maximization of rate of return, availability of capital for all sectors and geographic areas, maintenance of a viable and efficient system of intermediation, assurance of delivery of services and consumer protection. The function of the insuring agencies is very limited. They are in place to provide depositor security by monitoring institutional soundness (preventive) and paying off losses (curative). Elevation of the insurance function, and more particularly protection of the insurance fund over all other public interest considerations, is an unfounded, improper and distorted approach.

States willingly contribute resources to underwrite the maintenance of the current dual banking. The very existence of CSBS gives testimony to that fact. The high quality of banking departments throughout the country is a constant reminder of that commitment. State banks which are federally insured are willing to endure redundant and more costly supervision to keep the dual banking system alive. They contribute to the insurance fund and to the maintenance of the dual banking system every year. One would deceive his or herself to suggest that state supervisors or the banks they regulate have not paid their dues and

are not aware of the cost-pass-through which accompanies insurance agency pay-outs.

CSBS is actively supporting passage of H.R. 4603 in the Senate. That bill includes expanded authority for federal insurance agency infusion of funds. Our support for those provisions is in no way diminished by our position on primary regulator involvement in a "net worth guarantee" program.

It might be feasible to use a combination of the "net worth guarantee" concept with expanded statutory authority for federal insuring agencies to make loans to, make deposits in, purchase the assets or securities of or assume the liabilities of any insured commercial bank, savings bank or savings and loan association. The primary goal would be to facilitate the continued operation of well-managed but troubled institutions. Such a tiding over of troubled institutions could also help to avert other, more serious, negative consequences of the state of our economy.

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Question 4. Do we not also have to be concerned that the enactment of a massive assistance program might exacerbate the current economic problems by contributing to fears of continued high deficits, and high interest rates, and to fears of renewed inflation? Should we not be concerned that an adverse reaction in the financial markets might drive interest rates up and further endanger institutions which depend, first and foremost, upon interest rate relief to improve their prospects for survival?

Response: The question appropriately raises the psychological impact of establishing a new multibillion dollar expenditure program or, by inaction, continuing the record-setting, on-budget expenditures associated with current insurance fund programs. To avoid either of these alternatives, CSBS has endorsed a net worth guarantee program which does not add to current deficits and which has an immediate budgetary impact close to zero, unless an aided institution in the program fails. Such an approach is preferable to other new programs which involve direct outlays or programs which require appropriation, obligation and use of funds; e.g., new treasury funds for the FSLIC Income Capital Certificate program. A net worth guarantee program could increase savers' confidence in thrift institutions while not contributing to inflationary expectations.

Question 5. Several witnesses have referred to a recent study by Wharton Econometric Forecasting Associates which purports to demonstrate that, "far and away the most expensive way to deal with problem thrifts, short of liquidation, is to force mergers for them."?
What is your evaluation of the study?
Do you have any opinion of your own as to the relative costs of alternative proposals to assist the industry?

Response: Examining in detail all aspects of an econometric study performed by recognized experts in the field is beyond the scope of the Conference. However, while criticisms of <u>any</u> such study may be made concerning economic assumptions, future cost factors and institutional responses in an environment outside of past experience, the Conference does believe that the <u>relative</u> ranking of budgetory costs of the alternatives examined by the study is consistent with experience. That is, the net worth guarantee program must have a lower budgetory cost than an income capital certificate (ICC) program of equal coverage since appropriations must be made of the ICC obligated funds <u>and</u> interest payments to aided thrifts must be regularly made. Add-on programs to either a net worth guarantee or ICC program would clearly require more appropriations and expenditures than either a net worth guarantee or ICC program standing alone. Reliance on merger and acquisition policy alone, with

cash assistance, purchase of assets, periodic income maintenance payments and promises of future cash payments if interest rates rise will also have a direct budgetory impact, although the first few billion dollars spent would be from the insurance funds, rather than directly from the Treasury.

The Conference has supported the net worth guarantee concept because it is the program which appears to have the lowest immediate budgetory cost while still bringing effective aid to troubled, but well-managed thrifts.

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

April 6, 1982

Ms. Muriel Siebert
Superintendent of Banks
New York State Banking Department
Two World Trade Center
New York, New York 10047

Dear Muriel:

Your recent testimony on H.R. 5568, the Home Mortgage Capital Stability Act, before the Subcommittee on Housing and Community Development has been received with great interest and studied closely by Minority Members and Committee staff.

Unfortunately, the limited amount of time available at the hearings did not permit as full a discussion of the issues as we would have liked. However, the Minority staff has developed a series of questions designed to give the witnesses a fuller opportunity to present their views for the record.

It would be very helpful, therefore, if you would respond to the attached list of questions. In order to ensure that your answers will be included in the hearing record, they should be received no later than April 16.

Thank you for your cooperation.

Sincerely,

J. William Stanton

JWS:bfd

Attachment

QUESTIONS FOR MS. SIEBERT:

1. ON PAGE 3 YOU STATE THAT, "H.R. 5568 PROVIDES A MEANS OF CONTINUED EXISTENCE FOR THRIFTS THAT 1) ARE MOST TROUBLED, BUT 2) EXHIBIT A REALISTIC POTENTIAL FOR FUTURE VIABILITY."

IS IT POSSIBLE TO MAKE AN OBJECTIVE SELECTION OF SUCH INSTITUTIONS, GIVEN THE TREMENDOUS POLITICAL PRESSURE AND THE THREAT OF LAW SUITS BY DISAPPOINTED APPLICANTS, WITHOUT ASSISTING INSTITUTIONS WHICH ARE SO TROUBLED THAT THEY CAN NOT MAKE EFFECTIVE USE OF THE ASSISTANCE? MIGHT THE CONTINUED EXISTENCE OF SUCH INSTITUTIONS NOT INCREASE THE PRESSURE ON THOSE INSTITUTIONS WHICH ARE RELATIVELY HEALTHY AND WHICH WILL BE CALLED UPON TO COMPETE AGAINST FEDERALLY-ASSISTED INSTITUTIONS?

2. ON PAGE 6 YOU STATE, "IF THE PRIME REGULATOR IS TO BE GIVEN THIS RESPONSIBILITY, THOUGH, HE OR SHE HAS AN OBLIGATION AS WELL. .... REGULATORS MUST TAKE THE INITIATIVE TO SEE THAT VIABILITY IS INSURED BY SEEING TO IT THAT COSTS ARE REDUCED AS MUCH AS POSSIBLE TO MINIMIZE THE FINANCIAL ASSISTANCE NEEDED FROM THE FEDERAL GOVERNMENT."

IF STATE REGULATORS SHOULD INFLUENCE THE DECISION AS TO WHICH INSTITUTIONS RECEIVE ASSISTANCE, SHOULD THE STATES ALSO MAKE A FINANCIAL CONTRIBUTION, TO INDEMNIFY THE FEDERAL AGENCIES AGAINST THE CONSEQUENCES OF DECISION INFLUENCED BY CONSIDERATION OF STATE POLICIES?

3. PERHAPS ONE OF THE CONTRIBUTIONS THAT STATES CAN MAKE, AS SUGGESTED BY CHAIRMAN ISSAC OF THE FDIC, IS TO REPEAL OR SUFFER THE PREEMPTION OF WHAT CHAIRMAN ISSAC CALLED "UNFAIR AND BURDENSOME" STATE AND LOCAL FRANCHISE TAXES.

WHAT IS THE COST OF THESE TAXES TO THE INSTITUTIONS UNDER YOUR SUPERVISION?

WHAT IS YOUR POSITION ON REPEAL OR PREEMPTION OF THESE TAXES?

4. ON PAGE 8 YOU STATE, "IF WE ARE TO JUSTIFY THIS LEGISLATION, WE MUST JUSTIFY THE USEFULNESS OF THRIFT INSTITUTIONS IN AMERICAN SOCIETY. THEY MUST CONTINUE TO BE, AS THEY HAVE BEEN IN THE PAST, THE PRINCIPAL SOURCE OF HOME FINANCING FOR THE AMERICAN FAMILY."

IS IT POSSIBLE, GIVEN THE ALREADY DIMINISHED ROLE OF THRIFT INSTITUTIONS IN HOUSING FINANCE, THE EVIDENCE THAT THE DAMAGE TO THE INDUSTRY MIGHT BE PERMANENT, AND THE FACT THAT OTHER INSTITUTIONS HAVE ALREADY MOVED TO PICK UP THE SLACK, THAT THE THRIFT INSTITUTIONS WILL NEVER ASSUME THEIR FORMER ROLE AND THAT THE LEGISLATION CAN NOT BE JUSTIFIED ON THIS BASIS?

5. ON PAGES 8 AND 9 YOU SUGGEST THAT AN EXCEPTION TO THE MORTGAGE LENDING REQUIREMENT BE MADE FOR "THOSE THRIFTS THAT HAVE ENGAGED IN HEAVY BORROWING TO MEET LIQUIDITY REQUIREMENTS OR TO COPE WITH DEPOSIT OUTFLOWS?"

IS THERE ANY DIFFICULTY IN IDENTIFYING THESE INSTITUTIONS? WHAT PERCENTAGE OF THE TOTAL NUMBER OF INSTITUTIONS AND ASSETS WOULD THEY REPRESENT?

6. ON PAGES 9 AND 10 YOU RECOMMEND THAT INSURANCE BE EXTENDED TO ALL DEPOSITS, THAT THE PRESENT $100,000 LIMIT BE REMOVED.

WHAT WOULD BE YOUR RESPONSE TO AN OBJECTION THAT THIS STEP WOULD REMOVE ONE THE LAST VESTIGES OF DISCIPLINE UPON THE PRUDENCE AND COMPETENCE OF MANAGEMENT, BY REMOVING THE INCENTIVE FOR SOPHISTICATED DEPOSITORS TO CONSIDER THE QUALITY OF AN INSTITUTION IN DECIDING WHERE TO PLACE THEIR FUNDS?

STATE OF NEW YORK
BANKING DEPARTMENT
TWO WORLD TRADE CENTER
NEW YORK, N.Y. 10047

MURIEL SIEBERT
SUPERINTENDENT

April 22, 1982

Honorable J. William Stanton
Congressman
U.S. House of Representatives
Committee on Banking, Finance
and Urban Affairs
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Bill:

I was sorry to hear about your illness and I hope you are well on the road to complete recovery by now.

In your letter of April 6, you raised a number of questions regarding my recent testimony. My responses are numbered below to coincide with the numbers of your questions.

1) Based upon our in-depth knowledge of the financial condition of the institutions we supervise, of the quality and composition of their assets and liabilities, and of their management capability and depth, we have a good idea of which institutions have a realistic potential for future viability. We also see no reason to believe that those institutions that are relatively healthy will be significantly disadvantaged by having to compete with banks to which financial assistance has been provided.

However, I am not actively opposed to attempting to encourage banks to merge where they [illegible]. We anticipate that this can lead to [illegible] cost economies through elimination of overlapping branch facilities, of duplicative management staffs, etc. By achieving these economies, such mergers would not only help to [illegible] for these institutions but would minimize the eventual cost of FDIC assistance.

2) Savings banks and savings and loan associations have contributed to the FDIC and the FSLIC insurance funds for decades. We believe that these insurance funds are the appropriate vehicle for providing the financial assistance necessary in connection with supervisory mergers. As I indicated above, we are attempting to arrange mergers among thrift institutions that will substantially reduce operating expenses so as to minimize the amount of financial assistance which the insurance funds will have to provide

3) New York State and New York City franchise taxes paid by savings banks and savings and loan associations were about $110 million during 1981. At a time when these institutions are suffering substantial operating losses, I do not believe that it is fair or equitable that these taxes should be levied on thrift institutions and I have stated this position publicly. Last year, at my urging and with the support of the Governor, the New York State Legislature reduced franchise taxes somewhat, although not to the extent that I would have preferred. I have also expressed my support for a federal preemption of such taxes for institutions that receive federal financial assistance.

4 I cannot agree with the implications of your question. While the high interest rates of recent years have caused operating losses and substantial deposit outflows thereby limiting the role of thrift institutions in housing finance, I do not believe that this is a permanent situation: Nor do I accept the view that interest rates will forever stay at the high levels of recent years. When interest rates do come down to more reasonable levels, the thrift industry, which has expertise in mortgage financing and which now has new alternative mortgage investment vehicles, should be able to function profitably in this area and will be able to reassume its important role in financing housing in this country.

As for your comment that other institutions are picking up the slack, I would be interested to see the evidence you have for this. While I would certainly welcome additional activity in providing housing finance on the part of the large commercial banks, insurance companies, pension funds, etc , I do not yet see any empirical data to support the contention that the long-standing commitment to housing finance by savings banks and savings and loan associations will in fact be assumed by these other institutions.

5) Our statistics would enable us readily to identify those institutions that have engaged in heavy borrowing to meet liquidity requirements or to keep up with deposit outflows. We do not believe that enabling institutions to use deposit inflows to repay borrowings would materially limit the degree of overall commitment to the mortgage market. For example, of the 99 state-chartered savings banks in New York with total assets of $83 billion at year-end 1981, three banks with total assets of about $4.5 billion were involved in heavy borrowing (over 10% of their total assets) as of that date. Of the 34 state-chartered savings and loan associations in New York with assets of about $4 billion, the comparable figures are five institutions with $ 1/2 billion of assets.

6) The current problems of the thrift institutions basically reflect the fact that interest rates have escalated sharply in recent years, thereby substantially increasing the expense of interest and dividend payments to depositors while on the asset side of the balance sheet, they are locked into long term (25-30 year) mortgages, many of which were made years ago when market interest rates were much lower than they are today and when many state usury ceilings limited the rates on such loans. As a result, their interest income from these loans is far below their interest payouts to depositors.

These high interest rates caused by the double-digit and near double-digit inflation rates of recent years, have been beyond the capability of bank management to deal with Given these circumstances, I do not believe that extending insurance to all deposits will eliminate discipline on management. Remember that the insurance funds protect depositors not the management of the banks. As you know, in the supervisory mergers of thrift institutions that have taken place in New York, in every case the top management of the bank as well as the entire board of trustees were required to resign their positions Extension of insurance to all deposits therefore would not remove the discipline on the prudence and competence of management.

It should also be kept in mind that the failures of the thrifts have not been caused by their making bad loans or by speculation. Instead, they have arisen from the fact that the thrifts have performed the function mandated by public policy (including federal and state CRA laws and regulations), namely, to make loans in their local communities. This, combined with the fact that State laws both in New York and in many other states throughout the country, had in the past established unrealistic usury ceilings (which I opposed) contributed to the financial problems they now face.

Sincerely, & with kindest [illegible]

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

April 6, 1982

Mr. Gerald M. Lowrie
Executive Director of Government Relations
American Bankers Association
1120 Connecticut Avenue, N. W.
Washington, D. C. 20036

Dear Jerry:

Your recent testimony on H.R. 5568, the Home Mortgage Capital Stability Act, before the Subcommittee on Housing and Community Development has been received with great interest and studied closely by Minority Members and Committee staff.

Unfortunately, the limited amount of time available at the hearings did not permit as full a discussion of the issues as we would have liked. However, the Minority staff has developed a series of questions designed to give the witnesses a fuller opportunity to present their views for the record.

It would be very helpful, therefore, if you would respond to the attached list of questions. In order to ensure that your answers will be included in the hearing record, they should be received no later than April 16.

Thank you for your cooperation.

Sincerely,

Bill -

J. William Stanton

JWS:bfd

Attachment

QUESTIONS FOR MR. KENNEDY:

1. ON PAGE 5 YOU STATE, "SINCE THE LARGEST COMPETITION FACED BY DEPOSITORY INSTITUTIONS IS FROM MONEY MARKET FUNDS, DEPOSITORY INSTITUTIONS MUST HAVE SOME WAY OF GAINING BACK THE FUNDS THAT HAVE BEEN DRAWN AWAY BY THIS COMPETITOR." YOU STATE THAT YOUR PROPOSAL TO LOWER THE MINIMUM DENOMINATION OF CERTIFICATES NOT SUBJECT TO RATE CEILINGS WOULD LET BANKS "COMPETE MUCH MORE EFFECTIVELY FOR SOME RELATIVELY LARGE CONSUMER DEPOSITS AND, MORE IMPORTANTLY, THE LARGE AMOUNTS OF DEPOSITS FROM SMALL BUSINESSES, LOCAL GOVERNMENTS, AND NON-PROFIT INSTITUTIONS THAT ARE CURRENTLY BEING LOST TO MONEY MARKET FUNDS."

WOULD YOU OBJECT TO THRIFT INSTITUTIONS COMPETING FOR THE SAME BUSINESS? SPECIFICALLY, WHAT IS YOUR POSITION ON H.R. 5414, A PROPOSAL BY REP. BILL GRADISON TO PERMIT THRIFT INSTITUTIONS TO OFFER NOW ACCOUNTS TO STATE AND LOCAL GOVERNMENTS?

2. SEVERAL WITNESSES HAVE REFERRED TO A RECENT STUDY BY WHARTON ECONOMETRIC FORECASTING ASSOCIATES WHICH PURPORTS TO DEMONSTRATE THAT, "FAR AND AWAY THE MOST EXPENSIVE WAY TO DEAL WITH PROBLEM THRIFTS, SHORT OF LIQUIDATION, IS TO FORCE MERGERS FOR THEM."?

WHAT IS YOUR EVALUATION OF THE STUDY?

DO YOU HAVE ANY OPINION OF YOUR OWN AS TO THE RELATIVE COSTS OF ALTERNATIVE PROPOSALS TO ASSIST THE INDUSTRY?

3. ON PAGE 8 YOU STATE, "THERE SHOULD BE SOME DISINCENTIVES SUCH THAT THE USE OF THIS AID IS NOT CONSIDERED LIGHTLY. INSTITUTIONS THAT HAVE NEED OF AID BECAUSE OF POOR MANAGEMENT SHOULD NOT BE ELIGIBLE. MANY BANKERS PERCEIVE THAT SOME TROUBLED SAVINGS AND LOANS ARE NOT MAKING THE MANAGEMENT CHANGES NEEDED TO COPE WITH THE CHANGING REALITY. MUCH OF THE EVIDENCE IS ANECDOTAL BUT THE FEELING IS WIDESPREAD AMONG BANKERS THAT THIS IS TRUE."

THE INDEPENDENT BANKERS HAVE REFERRED TO A STATEMENT BY SANFORD ROSE IN THE MARCH 23 AMERICAN BANKER THAT "IF THE SAVINGS BANKS AND SAVINGS AND LOANS HAD UNDERTAKEN TO HEDGE THEIR MONEY-MARKET CERTIFICATES WHEN THE CERTIFICATES WERE FIRST INTRODUCED IN MAY 1978, THERE WOULD TODAY BE NO CRISIS IN THE THRIFT INDUSTRY."

IS THIS EVIDENCE THAT THE PROBLEMS OF THE THRIFT INSTITUTIONS ARE DUE IN LARGE MEASURE TO BAD MANAGEMENT, RATHER THAN TO ECONOMIC CIRCUMSTANCES AND CONGRESSIONAL ACTIONS BEYOND THEIR CONTROL? CAN YOU PROVIDE SOME EXAMPLES OF THE ANECDOTAL EVIDENCE TO WHICH YOU REFER?

4. ON PAGES 8 AND 9 YOU STATE, "ONCE THE ELIGIBLE INSTITUTIONS ARE DETERMINED AND THE AID IS GIVEN, THOSE INSTITUTIONS MUST BE ABLE TO USE THE AID IN THE MOST EFFICIENT MANNER. .... IF THE BORROWING INSTITUTIONS THAT ARE ELIGIBLE ... ARE TOO HEAVILY CONTROLLED, THEY WILL NOT BECOME PROFITABLE AND THE TAXPAYER WILL LOSE. IN SHORT, PUT RIGOROUS REQUIREMENTS ON DETERMINING WHICH INSTITUTIONS ARE ELIGIBLE FOR AID, BUT ONCE THE AID IS GIVEN, ALLOW THE INSTITUTIONS TO OPERATE IN THE MOST EFFICIENT MANNER."

IS THERE NOT A PRESUMPTION THAT THE INSTITUTIONS WHICH HAVE THE MANAGEMENTS MOST CAPABLE OF OPERATING WITHOUT STRINGS ATTACHED ARE THOSE WHICH ARE LEAST LIKELY TO NEED ASSISTANCE?

IS IT NOT EXTREMELY DIFFICULT TO PICK OUT THOSE PARTICULAR INSTITUTIONS WHICH ARE IN JUST ENOUGH TROUBLE TO NEED ASSISTANCE BUT WHICH ARE JUST WELL ENOUGH MANAGED TO MAKE USE OF IT?

IS IT REASONABLE TO EXPECT THE AGENCIES TO MAKE SUCH DETERMINATIONS IN THE FACE OF ENORMOUS POLITICAL PRESSURE AND THE THREAT OF LAW SUITS ON THE PART OF DISAPPOINTED APPLICANTS FOR ASSISTANCE?

CAN YOU SUGGEST HOW THE BILL MIGHT BE AMENDED TO PROVIDE A FAIR, OBJECTIVE, AND EFFICIENT METHOD OF DETERMINING WHICH INSTITUTIONS SHOULD RECEIVE ASSISTANCE?

5. WITH RESPECT TO EACH OF THE FOLLOWING PROVISIONS OF H.R. 5568, PLEASE ANSWER THE FOLLOWING GENERAL QUESTIONS:

1. HOW WOULD THE PROVISION WORK IN PRACTICE?
2. WOULD YOU DESCRIBE THE PROVISION AS "DESIRABLE"?
3. WOULD YOU DESCRIBE THE PROVISION AS "WORKABLE"?
4. WHAT SUGGESTIONS WOULD YOU OFFER TO AMEND THE PROVISION?

a. THE CAPITAL INFUSION PROGRAM DESIGNED TO MAINTAIN THE NET WORTH OF INDIVIDUAL INSTITUTIONS AT 2%. HOW MANY INSTITUTIONS (NUMBER AND TOTAL ASSETS) DO YOU ESTIMATE WOULD QUALIFY FOR THE PROGRAM TODAY? DO YOU BELIEVE THE SUPERVISORY AGENCIES CAN DETERMINE ELIGIBILITY WITH REASONABLE CERTAINTY AND FAIRNESS? SHOULD LIMITATIONS BE PLACED UPON THE PREROGATIVES OF MANAGEMENT, TO ENSURE THAT THE FEDERAL INTEREST IS PROTECTED AND TO CREATE A DISINCENTIVE FOR INSTITUTIONS TO APPLY FOR ASSISTANCE?

b. THE REPORTING AND LENDING PRACTICE REQUIREMENTS. WHAT IS MEANT BY LENDING PRACTICES? WOULD THE NEED TO ADMINISTER THIS PROVISION PLACE AN UNDUE BURDEN ON THE ALREADY STRAINED RESOURCES OF AGENCIES AND OF DEPOSITORY INSTITUTIONS?

c. THE REQUIREMENT THAT NOT LESS THAN 50% OF ANNUAL NET NEW DEPOSITS BE INVESTED IN SINGLE-FAMILY MORTGAGES FOR FIRST-TIME HOMEBUYERS WHO WOULD PAY 1% ABOVE THE INSTITUTION'S COST OF FUNDS. IS IT ANTICIPATED THAT THERE WILL BE ANY "NET NEW DEPOSITS" AT ALL? HOW MANY INDIVIDUALS WOULD QUALIFY AS FIRST-TIME HOMEBUYERS, AND HOW WOULD INSTITUTIONS ALLOCATE LIMITED FUNDS AMONG NUMEROUS APPLICANTS?

d. THE PROVISION FOR QUARTERLY "EARNINGS STABILIZATION PAYMENTS." IS IT SOUND PUBLIC POLICY TO PROVIDE "EARNINGS STABILIZATION" INSURANCE TO DEPOSITORY INSTITUTIONS? ARE THE FIGURES FOR 'EARNINGS LOSSES' SUBJECT TO UNDUE MANIPULATION BY THE INSTITUTIONS? HOW WOULD THE AGENCIES DETERMINE THAT PAYMENTS MAY CONTINUE AND MAKE THE REQUIRED CERTIFICATION "THAT THE CONTINUED EARNINGS LOSSES INVOLVED ARE CAUSED BY GENERAL MARKET CONDITIONS AND NOT BY THE ACTIONS OF SUCH QUALIFIED INSURED INSTITUTION"?

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1. Our Association is opposed to the expansion of NOW account eligibility. NOW accounts have only been allowed nationwide for a little more than a year. As envisioned in the Depository Institutions Deregulation and Monetary Control Act of 1980, the deregulation of deposit products of all types of depository institutions would occur gradually over the six-year period set forth in the legislation. The abrupt expansion of NOW account eligibility would impose unanticipated and significant costs on commercial banks while not providing them any additional ability to compete for deposits presently being drained off into money market mutual funds. Until the Depository Institutions Deregulation Committee acts to provide compeittive deposit products, on the one hand, and outdated state usury ceilings that limit banks' ability to pay competitive rates are removed, on the other, our Association would continue to oppose any expansion of NOW account eligibility. However, we do feel that all depository institutions should be treated the same with regard to expansion of NOW account eligibility. However, we do feel that all depository institutions should be treated the same with regard to expansion of NOW account eligibility. This position was upheld in the decision of a recent suit brought by the Association against the Federal Home Loan Bank Board. The Board interpreted the regulations more broadly than the Federal Reserve, resulting in commercial banks being restricted to a smaller market for NOW accounts than the savings and loans. The ruling specified that the customers eligible for NOW asccounts at thrifts and banks should be the same. Any expansion of NOW account eligibility to additional customers should apply to commercial banks and thrift institutions.

2. We have attached a copy of a memo evaluating the study. As pointed out in the memo, the estimates calculated by Wharton Econometric Association, Inc, are much higher than the actual costs of mergers. We feel that the Wharton study overestimates the cost of aiding thrift institutions through assisted mergers.

As we said in our testimony we feel that the present resources are adequate to protect the depositors of institutions. Alternative proposals that aid institutions rather than depositors will be more costly than the present policy of assisted mergers. To the extent that the alternative proposals increase the budget deficit, they will frustrate the fall in interest rates and the economy as a whole will bear the costs. To the extent that the proposals allow thrift institutions to ignore the realities of the market place, they will ultimately increase the cost to the industry. Thrift institutions will remain vulnerable to unexpected changes in the economy as long as their portfolio is not diversified.

3. The question of poor management by any institution is hard to document. Most of the anecdotal evidence about savings and loans concerns policies that are visible to outside observers. Two areas that have been mentioned are the opening of branches by institutions that are in bad financial shape and unwise pricing of loans or rates paid on accounts. Although it is very difficult to obtain explicit data on either of these questions, some figures on new branches can be cited. During 1981, 499 applications for loan branches were approved by the FHLBB and 4 were denied. From January 1, 1982 through March 31, 1982 62 applications were approved by the FHLBB. For an industry that is in such poor shape,this is a large number of new branches to be opened.

The use of hedging to prevent losses is a fairly new technique in which expertise must be gained. If hedging is not carried out correctly, it may not protect the earnings from variations in interest rates. Because it is a new technique and there are some risks in its use, the absence of hedging should in 1978 should not be taken as an indication of bad management.

4. Although many of the institutions losing money are the victims of market conditions and should be eligible for aid, some of the problems of the institutions may be compounded by bad management and these should not be eligible for aid. Indications of these institutions would be ones that are doing worse than their peers in the same market area. In addition, comparisons of non-interest expense and return on assets with the industry average could be used as indicators of management.

The regulators must decide between extension of aid or assisted mergers. Although they may be faced with various pressures to extend aid, the agencies were established to regulate the institutions and should carry out their role. A potential problem is the behavior of the FHLBB in determining which institution to aid. It has been set up to be a cheerleader as well as a regulator and may be unwilling to act as a regulator in this case.

The bill should be amended to give the regulators discretion in determining the institutions to receive aid. Criteria for receiving aid could include the following: the institution should be viable in the longrun, the institutions should play a large role in meeting the financial needs of the community, the institution has utilized reasonable efforts to maintain viability.

5a. As written, the provision would not work and would be undesireable. Institutions would have an incentive to reach 2% net worth by selling low rate mortages and would have no incentive to increase net worth above 3%. Instead of this, the regulators should be given the discretion to determine which instituitons need aid. In addition, provisions are needed to prevent institutions from using the aid program as a means of decreasing their holdings of low rate mortgages.

As of June 1981, according to the FHLBB call report data, there are 148 savings and loan associaitons that qualify. Their assets total $17.8 billion, and their losses for the six months through June 1981 total $160 million. The magnitude of these figures will have increased by now. No savings banks or commercial banks are eligible.

The supervisory agencies should be able to determine eligibility. Since they are familiar with the management of the institutions through their oversight responsibilities, they should do a much better job than would occur with a simple rule.

5b. It is unclear exactly what is meant by the reporting and lending practice requirement. As written, the provision is unworkable and undesireable and would increase the reporting burden of all concerned.

5c. The provision would be difficult to apply. There would be problems determining how the low rate loans would be allocated. The provision is unworkable and undesireable and should be dropped. As we stated in our testmony the provision would make thrift instittions worse off.

During 1981, there were only three months when net new deposits increased. As long as interest rates remain high, and depository institutions lack the instruments to compete with money market funds there is little chance of substantial increase in net new deposits.

5d. This provision would be workable but is undesireable. There are problems with it as written because institutions would have an incentive to keep below 3 % net worth once they receive aid. This could be done by selling low rate mortgages which would keep their net worth below 3% and is a backdoor way of resolving the low interest rate mortgage problem. If allowed to occur, this would increase the costs of the program immensely. The conditions set on the payments would be very difficult to monitor. It is unclear how this could be accomplished.

AMERICAN
BANKERS
ASSOCIATION

MEMORANDUM

April 5, 1982

TO: Mike Laub

FROM: James Seaver

RE: Cost of thrift industry mergers

Two studies have recently been published on the thrift industry and its current problems: 'The Plight of the Thrift Institutions', written by Andrew Carron of the Brookings Institution, and 'Report of the Financial Implications of Different Governmental Policies for the Thrift Industry', Wharton Econometric Forecasting Associates, Inc.

The main disagreement between the two studies, and the one with major policy implications, is the difference in the cost of assisted mergers to aid the distressed institutions. Carron concluded that the net cost of assisted mergers could reach \$6.4 billion for the FSLIC and \$2.1 billion for the FDIC through 1983. Similar figures for the Wharton study through 1983 are \$41.3 billion and \$13.6, approximately 7 times the estimate by Carron.

The differences in cost estimates could arise from two sources, the estimated number of institutions aided could differ in the two studies or the calculation of the cost of aid for each institution could differ. This memo presents the assumptions used and analyses the reasons for the difference in costs.

I. Basic assumptions of the models

The Wharton study looks at the cost of aid under different scenarios. The base or "most likely" scenario, (the publicized results have assumed this scenario) assumes, among other things, that personal tax rates decrease by 10% on July 1, 1982, and again on July 1, 1983. Also, the Fed maintains its policy of restraining the growth of money supply, resulting in an M-1 growth of 6.2% and 5.2% in 1983. This results in a 3 month Treasury bill rate of 13.3% in 1982, 14.3% in 1983, and 12.7% in 1984. Carron assumes three different interest rate assumptions: optimistic, consensus and pessimistic. The average six-month Treasury bill discount rate over the 1981-83 period for the three assumptions is 11.70, 12.71 and 13.60 respectively. The pessimistic assumption corresponds relatively well to Wharton's base scenario.

The studies examine the cost of aid to savings and loan associations as well as to mutual savings banks. Since the conclusions given in this memo are relevant for both groups, the results for the savings and loans will be emphasized.

The Wharton study estimates many different variations on their model. This memo concentrates on their results that have been most heavily publicized. Those results assume the "most likely" economic conditions, as well as a turnover rate of twelve and a half years for mortgage portfolios.

II. Number of institutions aided.

Each study makes different assumptions about when the institutions are eligible for aid. The Wharton study assumes that aid is given when the net worth to asset ratio of an institution reaches a certain point, either 0 percent or 1 percent. Carron uses a different criterion for the point at which aid is needed.

> "The ultimate criterion of viability is whether there exists sufficient net worth to allow positive net income at some future time when the nteres rate yie d curve is normal, assets have been fully marked down to market va ue nd liabilities earn a market rate of return in a deregul ted environment. This indicator of long-run viability can be used in conjunction with other criteria such as net worth ratios (net worth to assets or net worth to net income) and liquidity ratios (liquid assets to savings plus short-term borrowings) to assess the performance of the industry." [1]

Carron also takes into account the fact that some institutions may not be viable because of high operating cost resulting from bad management or small size rather than market conditions. He does this by comparing the operating costs of institution to the industry average. He concludes that many of the non-viable institutions will be merged with healthier firms and would not need assistance from the FSLIC or FDIC.

Because of the different methods of determining which institutions need aid, particularly since Carron takes into account unassisted mergers, the number of institutions aided may differ and cause the variation in the cost estimates. However, this does not seem to be the case. Table 1 lists the number of institutions ded under each study. The numbers although different, are comparable. Wharton using net worth criterion of 1% estimates 154 savings and loans will need assistance in 1982 and 388 will need assistance in 1983, totaling 542. Carron estimates that through 1983 under the conservative assumption 347 would need assistance through 1983 and under the pessimistic assumption 625 would need assistance through 1983. His estimates bracket the Wharton studies estimates. This would indicate that the difference in the cost estimates is due to the assumption of the cost of aid for the institutions.

III. Cost of aiding non-viable institutions

Carron does not give any explanation of how he calculates the cost of FSLIC aid to the institutions. However the cost would be due to taking over of low rate assets, cash grants to the merger partner or other aid to facilitate the merger. The Wharton study is much more explicit in its determination of the cost of aid. It assumes the following for assisted mergers:

1 Andrew Carron, The Plight of the Thrifts, pg. 28

"The FDIC or FSLIC writes off, over the next 12 quarters, any FHLB or Federal Reserve advances currently on the thrift's books. An equivalent amount of assets at book value are assumed liquidated by the insurer. The insurer can be expected to receive about 60¢ on the dollar from the liquidation of these assets. If the thrift has no advances the insurer may still assume some of the assets of the merged thrift. The proportion of assets assumed was about 19% in the Greenwich merger, and less in later merger. The proportion of assets assumed by the insurer can be varied in the program. The tables in Section 4 show the costs when net up front losses to the insurer are 2% or 4% of the assets. Any ongoing losses of the thrift are paid for by the insurer as part of the income maintenance provisions."[2]

As can be seen in table 1, Carron estimates the cost of the savings and loan assisted mergers under the pessimistic assumption to be $6.4 billion. To determine how realistic this is, we can compare the cost of aid to the assets of the aided institutions (year end 1980) of $83.4 billion. The estimated cost of assistance is 7.67% of the assets of the institutions aided. This is in line with the estimates of the costs to the FSLIC of assisted mergers for the last half of 1981. Pratt, in recent testimony, stated that for the last 7 months of 1981, there were 23 assisted mergers of institutions totaling $12.3 billion in assets, with a present value cost to the FSLIC of $633 million or 5.1% of assets.[3] Thus the Carron estimates should be a reasonable estimate of the cost.

The Wharton study gives two different estimates of the cost of assisted merger depending upon the percent of assets taken over. If 2% of assets are taken over, the cost would be $27.7 billion through 1983. If 4% of the assets were taken over, the cost would be $37.2 billion through 1983. These estimates are 4 to 6 times higher than Carron estimates. The Wharton study does not give the assets of the aided institution so it is impossible to calculate the cost as a percent of assets. However, since the calculation of the number of institutions aided is less in the Wharton study than under Carrons pessimistic scenario, the difference in cost estimates must be due to a higher net cost of aid to the FSLIC per institution, much higher than that estimated by Carron or indicated by previous mergers.

IV Conclusion

The difference in cost estimates seems to be due to the difference in calculating the cost of assisted mergers per institution. Carron's estimates agree closely with the experience of the FSLIC in the last 7 months of 1981. The higher Wharton estimate may be due to not assuming purchase accounting as well as ignoring the recent experience of the FSLIC or the FDIC. This can be checked by assuming the higher merger cost that occurred in early 1981. Mergers in the first part of 1981 by the FSLIC had a present value cost to the FSLIC estimated at 22% at assets of mergers institution. Using this figure and Carron's estimate of the assets of non-viable institutions assisted by the FSLIC, the cost would be $18.2 billion ($83.4 billion x .22). This is still significantly lower than the cost estimates of the Wharton study, which range from $27.7 to $37.2 billion.

If one accepts the estimates of the number aided, and they are fairly consistent between the two studies, the difference in estimated cost must be due to a much higher cost of aiding each institution. The Wharton estimate is too high and does not accurately reflect the cost of assisted mergers.

2 Wharton Econometric Forecasting Associates, Report on the Financial Implications of Different Government Policies for the Thrift Industry." pg. 11

3 Statement of Richard T. Pratt, Chairman of the FHLBB on H.R. 5568, March 24, 1982, pg. 11-12

Table 1

Comparison of Wharton and Brooking Analysis

of Aid to Thrift Institutions

Brookings

	Interest rate Assumption Optimistic	Consensus	Pessimistic
Number of S&L's viable with merger, not requiring assistance (through 1983)	412	433	451
S&L's requiring assistance (through 1983)			
Number	197	347	625
Assets ($ Billions)	26.7	48.8	83.4
Cost of Assistance ($ Billions)	2.5	4.1	6.4

Savings and Loans Requiring Assistance

Wharton

	Number	Cost Assuming Net Up Front Loss as Percent of Assets ($ Billions) 2%	4%
1982	154	3.4	4.6
1983	388	24.3	32.6
Total through 1983	542	27.7	37.2

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

NINETY-SEVENTH CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, D.C. 20515

April 6, 1982

Mr. Kenneth A. Guenther
Executive Director
Independent Bankers Association
  of America
1625 Massachusetts Avenue, N. W.
Suite 202
Washington, D. C. 20036

Dear Ken:

Your recent testimony on H.R. 5568, the Home Mortgage Capital Stability Act, before the Subcommittee on Housing and Community Development has been received with great interest and studied closely by Minority Members and Committee staff.

Unfortunately, the limited amount of time available at the hearings did not permit as full a discussion of the issues as we would have liked. However, the Minority staff has developed a series of questions designed to give the witnesses a fuller opportunity to present their views for the record.

It would be very helpful, therefore, if you would respond to the attached list of questions. In order to ensure that your answers will be included in the hearing record, they should be received no later than April 16.

Thank you for your cooperation.

Sincerely,

J. William Stanton

JWS:bfd

Attachment

QUESTIONS FOR MR. HARRIS:

1. ON PAGES 3 AND 4 YOU STATE, "THE PROSPECT OF CONTINUING HIGH FEDERAL DEFICITS FOR YEARS TO COME IS LARGELY RESPONSIBLE FOR HIGH LONG-TERM INTEREST LEVELS WHICH EXACERBATE THE THRIFT CRISIS,... IT IS THEREFORE IMPERATIVE THAT THE CONGRESS AND THE ADMINISTRATION GET ON WITH THE JOB OF BRINGING OUR NATION'S BUDGET INTO BETTER BALANCE."

ON PAGE 10 YOU STATE, "NO ONE LIKES TO CONTEMPLATE A THRIFT ASSISTANCE PROGRAM COSTING BILLIONS AT A TIME WHEN PROJECTED FEDERAL DEFICITS ARE STAGGERING. BUT THE COST IS THERE AND IT WILL BE PAID ONE WAY OR ANOTHER."

HOW CAN CONGRESS AND THE ADMINISTRATION BRING THE BUDGET INTO BETTER BALANCE AND AT THE SAME TIME FINANCE A MASSIVE ASSISTANCE PROGRAM FOR THRIFT INSTITUTIONS?

SHOULD CONGRESS BE CONCERNED THAT THE ENACTMENT OF SUCH A PROGRAM MIGHT EXACERBATE THE CURRENT ECONOMIC PROBLEMS BY CONTRIBUTING TO FEARS OF CONTINUED HIGH DEFICITS, AND HIGH INTEREST RATES, AND TO FEARS OF RENEWED INFLATION, AND THAT AN ADVERSE REACTION IN THE FINANCIAL MARKETS MIGHT DRIVE INTEREST RATES UP AND FURTHER ENDANGER INSTITUTIONS WHICH DEPEND, FIRST AND FOREMOST, UPON INTEREST RATE RELIEF TO IMPROVE THEIR PROSPECTS FOR SURVIVAL?

2. ON PAGE 5 YOU STATE, "THERE MAY WELL BE A SMALL NUMBER OF COMMERCIAL BANKS WITH MORTGAGE PORTFOLIOS IN EXCESS OF TWENTY PERCENT OF ASSETS WHO FACE CRITICAL NET WORTH PROBLEMS. .... I WOULD URGE THAT THE LEGISLATION BE PREFECTED TO PERMIT PARTICIPATION BY THOSE COMMERCIAL BANKS WHO REQUIRE SUCH ASSISTANCE. THIS WILL REQUIRE A RECOGNITION THAT THE TWO PERCENT NET WORTH LEVEL SPECIFIED IN THE INITIAL BILL IS IRRELEVANT TO COMMERCIAL BANKS, (WHICH) WOULD BE UNLIKELY TO BE PERMITTED TO FALL BELOW A SIX PERCENT NET WORTH LEVEL BY OUR REGULATORS."

HOW MANY BANKS DO YOU ESTIMATE WOULD BE ELIGIBLE UNDER YOUR FORMULA?

CAN YOU SUGGEST AMENDATORY LANGUAGE TO MAKE THESE BANKS ELIGIBLE?

3. ON PAGES 6 AND 7 YOU STATE THAT ASSISTANCE LEGISLATION FOR TROUBLED DEPOSITORY INSTITUTIONS "CAN BRING THE RUSH OF MERGERS TO A VIRTUAL HALT, AND THEREBY LIMIT THE FINANCIAL CONCENTRATION AND LOSS OF LOCAL CONTROL WHICH ACCOMPANIES SUCH ACTIONS (,) AND IT AVOIDS THE DISASTROUS IMPACT ON OUR FINANCIAL STRUCTURE THAT WOULD RESULT WERE THE FEDERAL RESERVE BOARD TO PERMIT THE TAKEOVER OF A SAVINGS AND LOAN BY A BANK HOLDING COMPANY (WHICH) WOULD UNDERMINE THE INTRASTATE BRANCHING SYSTEMS OF THE SEPARATE STATES, ERASE THE BOUNDARY LINE BETWEEN BANKING AND COMMERCE, AND ERODE THE DOUGLAS AMENDMENT TO THE BANK HOLDING COMPANY ACT(, WHICH WOULD) DESTROY THAT EMBODIMENT OF FEDERALISM ... WHICH ACCORDS THE STATES A DOMINANT VOICE IN DETERMINING THE FINANCIAL STRUCTURE WITHIN THEIR BORDERS. THIS SYSTEM RECOGNIZES THE IMPORTANCE OF LOCAL DECISION-MAKING IN THE GRANTING OF CREDIT, AND THE DANGERS OF EXCESSIVE FINANCIAL CONCENTRATION."

ASSUMING THAT IT WOULD BE DESIRABLE TO MAINTAIN THE SYSTEM YOU DESCRIBE, IS IT PRACTICAL TO DO SO IN THE FACE OF RAPID INNOVATION IN COMMUNICATIONS TECHNOLOGY?

IS IT NOT LIKELY THAT ATTEMPTS TO MAINTAIN THE PRESENT SYSTEM WILL BE SUBJECT TO INCREASING PRESSURE AS SMALL BANKS FIND IT INCREASINGLY DIFFICULT TO SUPPORT THEIR EXISTING OVERHEAD? WHO WILL PAY TO MAINTAIN THIS SYSTEM, IF IT TURNS OUT THAT PERIODIC SUPPORT FOR TROUBLED INSTITUTIONS IS NECESSARY?

IS THE CONCENTRATION WHICH YOU FEAR NOT MITIGATED BY THE ENTRY OF NONDEPOSITORY AND OUT-OF-STATE FIRMS, WHICH OFFER THE RETAIL CUSTOMER AN EXPANDED CHOICE AND A PLACE TO APPEAL AN ADVERSE CREDIT DECISION BY A LOCAL INSTITUTION?

4. ON PAGE 9 YOU ASK WHETHER ADDITIONAL ASSISTANCE IS REQUIRED, "TO PRESERVE THE DECISION-MAKING ROLE OF THE CONGRESS ON BASIC PUBLIC POLICY ISSUES(, GIVEN THAT) "A CONTINUED MERGER WAVE, PARTICULARLY WERE IT TO INVOLVE BANK HOLDING COMPANY TAKEOVERS OF SAVINGS AND LOANS ... WILL EFFECTIVELY VOID A LARGE BODY OF STATE AND FEDERAL LAW. ...

"IF CHANGES IN THE FINANCIAL STRUCTURE ARE TO COME, THEY SHOULD BE THE RESULT OF CAREFUL AND REASONED DELIBERATION, NOT SECRET WEEKEND MERGERS. IF INDIVIDUAL INSTITUTIONS ARE TO DISAPPEAR, IT SHOULD BE BECAUSE THEY HAVE BEEN ELIMINATED BY FREE COMPETITION, AND NOT BECAUSE THE DEREGULATION TRANSITION HAS BEEN MISHANDLED."

HOW LONG CAN THE PROCESS OF DELIBERATION WHICH YOU DESCRIBE BE PERMITTED TO CONTINUE WITHOUT THE COSTS OF ASSISTING NONCOMPETITIVE DEPOSITORY INSTITUTIONS BECOMING EXCESSIVELY HIGH?

IS THERE NOT AN EQUAL DANGER THAT AS TIME GOES ON, INSTITUTIONS WHICH WOULD HAVE BEEN ELIMINATED BY FREE COMPETITION WILL BE PRESERVED, AT GREAT COST TO THE TAXPAYERS AND TO THE GENERAL ECONOMY?

5. ON PAGE 12 YOU STATE, "THE IBAA's OPPOSITION TO THE GRANTING OF COMMERCIAL ACCOUNT AND LENDING POWERS TO THRIFTS IS BASED UPON THE DAMAGE THIS WOULD WREAK UPON THE FINANCIAL STRUCTURE, IN ADVANCE OF ADEQUATE CONGRESSIONAL DELIBERATION REGARDING THE UNDERLYING PUBLIC POLICY CONSIDERATIONS, INCLUDING THE ISSUE OF THE INSTITUTIONAL STRUCTURE FOR THE FUTURE FINANCING OF OUR NATION'S HOUSING NEEDS."

HOW DO YOU RESPOND TO THE STATEMENTS BY THE CHAIRMEN OF THE FDIC AND THE FEDERAL HOME LOAN BANK BOARD THAT THE GREATEST NEED OF THE THRIFT INSTITUTIONS IS FOR NEW POWERS, TO ENABLE THEM TO COMPETE IN THE BROAD MARKET PLACE, THAT THIS WOULD SERVE THE LONG-RUN INTERESTS OF HOUSING FINANCE? IN LIGHT OF THE DAMAGE WHICH HAS ALREADY BEEN DONE TO THE ABILITY OF THRIFT INSTITUTIONS TO FINANCE HOUSING, CONFIRMED BY THE REGULATORS OF THESE INSTITUTIONS, AND IN LIGHT OF THE SUPPORT FOR HOUSING PROVIDED BY OTHER INSTITUTIONS AND BY THE SECONDARY MARKET, IS IT REASONABLE TO BELIEVE THAT SUPPORT FOR HOUSING BY THRIFT INSTITUTIONS CAN EVER RETURN TO FORMER LEVELS IN THE ABSENCE OF NEW POWERS?

6. ON PAGE 13 YOU ELABORATE ON YOUR OPPOSITION TO THE GRANTING OF COMMERCIAL POWERS TO THRIFT INSTITUTIONS ON THE GROUND THAT SUCH POWERS WOULD NOT NECESSARILY HELP THRIFT INSTITUTIONS. YOU STATE, "COMMERCIAL POWERS ARE NOT THE ONLY ROUTE TO THAT OBJECTIVE (OF ATTAINING PROFITABILITY)."

GIVEN THAT COMMERCIAL POWERS ARE NOT THE ONLY ROUTE, SHOULD THOSE THRIFT INSTITUTIONS FOR WHOM IT MAY BE THE MOST PROMISING ROUTE NOT HAVE AN OPPORTUNITY TO MAKE USE OF IT? IS IT YOUR GREATEST CONCERN THAT INDEPENDENT BANKS MIGHT SUFFER LOSS OF MARKET SHARE AS A RESULT OF COMPETITION FROM THRIFT INSTITUTIONS?

SPECIFICALLY, WHAT IS YOUR POSITION ON H.R. 5414, A PROPOSAL BY REP. BILL GRADISON TO PERMIT THRIFT INSTITUTIONS TO OFFER NOW ACCOUNTS TO STATE AND LOCAL GOVERNMENTS?

7. ON PAGE 14 YOU REFER TO A STATEMENT BY SANFORD ROSE IN THE MARCH 23 AMERICAN BANKER THAT, "IF THE SAVINGS BANKS AND SAVINGS AND LOANS HAD UNDERTAKEN TO HEDGE THEIR MONEY-MARKET CERTIFICATES WHEN THE CERTIFICATES WERE FIRST INTRODUCED IN MAY 1978, THERE WOULD TODAY BE NO CRISIS IN THE THRIFT INDUSTRY."

YOU SUGGEST THAT THIS MEANS THAT THE THRIFT INSTITUTIONS COULD RETURN TO SPECIALIZATION IF THEY WOULD MAKE USE OF THE FUTURES MARKET. PERHAPS A MORE POWERFUL IMPLICATION IS THAT THE PROBLEMS FACED BY THESE INSTITUTIONS ARE DUE IN SUBSTANTIAL PART TO BAD MANAGEMENT, RATHER THAN TO ECONOMIC CONDITIONS BEYOND THEIR CONTROL.

PLEASE COMMENT.

8. ON PAGE 10 YOU STATE, "A STUDY JUST RELEASED BY WHARTON ECONOMETRIC FORECASTING ASSOCIATES PROJECTS THAT ASSISTANCE BY MERGER COULD COST MORE THAN TWICE AS MUCH AS DIRECT ASSISTANCE VIA MORTGAGE WAREHOUSING IT IS IMPERATIVE THAT THE CONGRESS REVIEW THAT ANALYSIS AND EVALUATE ITS ACCURACY."

WHAT IS YOUR EVALUATION OF THE ACCURACY OF THE STUDY AND OF THE RELATIVE COSTS OF ALTERNATIVE MEASURES TO ASSIST THRIFT INSTITUTIONS?

9. WITH RESPECT TO EACH OF THE FOLLOWING PROVISIONS OF H.R. 5568, PLEASE ANSWER THE FOLLOWING GENERAL QUESTIONS:

1. HOW WOULD THE PROVISION WORK IN PRACTICE?
2. WOULD YOU DESCRIBE THE PROVISION AS "DESIRABLE"?
3. WOULD YOU DESCRIBE THE PROVISION AS "WORKABLE"?
4. WHAT SUGGESTIONS WOULD YOU OFFER TO AMEND THE PROVISION?

a. <u>THE CAPITAL INFUSION PROGRAM DESIGNED TO MAINTAIN THE NET WORTH OF INDIVIDUAL INSTITUTIONS AT 2%.</u> HOW MANY INSTITUTIONS (NUMBER AND TOTAL ASSETS) DO YOU ESTIMATE WOULD QUALIFY FOR THE PROGRAM TODAY? DO YOU BELIEVE THE SUPERVISORY AGENCIES CAN DETERMINE ELIGIBILITY WITH REASONABLE CERTAINTY AND FAIRNESS? SHOULD LIMITATIONS BE PLACED UPON THE PREROGATIVES OF MANAGEMENT, TO ENSURE THAT THE FEDERAL INTEREST IS PROTECTED AND TO CREATE A DISINCENTIVE FOR INSTITUTIONS TO APPLY FOR ASSISTANCE?

b. <u>THE REPORTING AND LENDING PRACTICE REQUIREMENTS.</u> WHAT IS MEANT BY LENDING PRACTICES? WOULD THE NEED TO ADMINISTER THIS PROVISION PLACE AN UNDUE BURDEN ON THE ALREADY STRAINED RESOURCES OF AGENCIES AND OF DEPOSITORY INSTITUTIONS?

c. <u>THE REQUIREMENT THAT NOT LESS THAN 50% OF ANNUAL NET NEW DEPOSITS BE INVESTED IN SINGLE-FAMILY MORTGAGES FOR FIRST-TIME HOMEBUYERS WHO WOULD PAY 1% ABOVE THE INSTITUTION'S COST OF FUNDS.</u> IS IT ANTICIPATED THAT THERE WILL BE ANY "NET NEW DEPOSITS" AT ALL? HOW MANY INDIVIDUALS WOULD QUALIFY AS FIRST-TIME HOMEBUYERS, AND HOW WOULD INSTITUTIONS ALLOCATE LIMITED FUNDS AMONG NUMEROUS APPLICANTS?

d. <u>THE PROVISION FOR QUARTERLY "EARNINGS STABILIZATION PAYMENTS."</u> IS IT SOUND PUBLIC POLICY TO PROVIDE "EARNINGS STABILIZATION" INSURANCE TO DEPOSITORY INSTITUTIONS? ARE THE FIGURES FOR "EARNINGS LOSSES" SUBJECT TO UNDUE MANIPULATION BY THE INSTITUTIONS? HOW WOULD THE AGENCIES DETERMINE THAT PAYMENTS MAY CONTINUE AND MAKE THE REQUIRED CERTIFICATION "THAT THE CONTINUED EARNINGS LOSSES INVOLVED ARE CAUSED BY GENERAL MARKET CONDITIONS AND NOT BY THE ACTIONS OF SUCH QUALIFIED INSURED INSTITUTION"?

Independent BANKERS ASSOCIATION OF AMERICA

WASHINGTON OFFICE

1625 MASSACHUSETTS AVENUE N.W. · SUITE 202, WASHINGTON, D.C. 20036 202/332-8980

April 16, 1982

Honorable J. William Stanton
Committee on Banking, Finance
and Urban Affairs
House of Representatives
2129 Rayburn House Office Building
Washington, D. C. 20515

Dear Bill:

I was pleased to learn of the great interest with which this Association's testimony concerning H.R. 5568 was received by Minority Members and Banking Committee staff. I am enclosing, for your consideration and review, our responses to the set of questions which accompanied your letter of April 6. I certainly hope that this elaboration will prove of assistance in fashioning a legislative response which adequately responds to the plight of thrift institutions and, in so doing, strengthens the depository system and lays the groundwork for an era of vigorous but fair competition.

The IBAA is very pleased to cooperate in this manner.

The IBAA family would like to take this opportunity to wish you a quick and speedy recovery.

Sincerely,

Kenneth A. Guenther
Executive Director

Enclosure
cc w/ enc.: Hon. Fernand J. St Germain
Hon. Henry B. Gonzalez

Response of the Independent Bankers Association of America to Questions Propounded by the Minority Staff of the House Committee on Banking, Finance and Urban Affairs Concerning H.R. 5568, "The Home Mortgage Capital Stability Act"

1. In our testimony we advocate a two-tier approach to thrift assistance. The initial step would be to enact H.R. 5568 in its revised form, which will require appropriations but no outlays except in rare instances of thrift liquidation. This step will have no impact on the federal deficit. It will buy time.

   That additional time would be used for step two.

   Its first component is the reaching of a consensus, by the Congress and the Administration, on a budget and tax strategy which holds out the prospect of declining deficits during the next few years.

   Its second component is the enactment of the Regulators' bill in the form in which it won overwhelming House approval.

   Its third component recognizes that a lengthy period of continuing high interest rates will undermine the benefits of a net worth stabilization plan, and will culminate at some point in the need for either a very large number of assisted mergers, or direct financial assistance. To prepare for that contingency, the Congress must consider what steps best meet the goals of permitting meaningful deregulation of depository institutions, lest banks also join the ranks of troubled institutions maintaining public confidence in the financial system; and providing the most cost-effective means of meeting those objectives.

   Of course, the Congress must be concerned about the budgetary impact of a direct cash infusion strategy. But, before rejecting that means out-of-hand, it must also consider the potential impact on the federal deficit, on the economy and on public confidence, of no action The recently passed "Full Faith and Credit Resolution, as well as public statements of the Secretary of the Treasury, make clear that general Treasury funds will be drawn down if the deposit insurance funds are reduced to zero by mergers and liquidations The cost of that eventuality must be compared to that of mortgage warehousing and other alternative approaches.

2. The number of banks who would be eligible for net worth stabilization would be extremely limited. According to the FDIC's 1980 Annual Report, the number of problem banks at the end of that year stood at 217 (1.5 percent of all banks). Although unfavorable economic conditions may have caused the number of problem banks to increase since that time, the total is probably still below the previous peak of 385 reached in November, 1976. The number of banks eligible for net worth stabilization would be a subset of this group, inasmuch as the institution would have to meet the test of having at least 20 percent of assets invested in residential mortgages, as well as the other conditions set out in H.R. 5568.

We would suggest that the eligibility level for commercial banks be set in accordance with the standards for capital adequacy set by their federal regulator. Commercial banks overseen by the Comptroller of the Currency or the Federal Reserve Board, therefore, should become eligible to participate when they enter the "Zone 3" total capital to total assets ratio, as set out in the joint statement issued by those agencies regarding "Capital Adequacy Guidelines" on December 17, 1981. That ratio would be below 5.5% for regional organizations, and below 6.0% for community organizations. As for banks supervised by the FDIC, we would suggest that eligibility be set at the minimum acceptable level of adjusted equity capital, 5% of adjusted total assets, as set forth in that agency's December 17, 1981, "Statement of Policy on Capital".

We would also suggest that, for those state-chartered banks operating in states which have set a higher minimum standard than the supervising federal agency, the federal agency be given discretion to permit participation in the net worth stabilization program where the granting of that eligibility would be consistent with the public policy aims of the authorizing legislation.

3. The IBAA not only assumes that it is desirable to maintain the dual banking system, but asserts that it is imperative to do so if we are to maintain a decentralized financial system which permits local decision-making and is consistent with our Federalist form of government. We believe that rapid innovations in communications technology do not mandate concentration but facilitate decentralization. The declining cost and simplified operation of sophisticated computer services, and the development of bankers' banks to provide group services to independent banks, will help to ensure their continued viability. We also believe that market specialization and quality of service, rather than nationwide reach and a supermarket approach to services, will be the key to fiscal health for individual institutions. The cover story of Business Week's April 12, 1982, issue reached the same conclusion.

We do not believe that maintenance of the dual banking system makes it likely that small banks will face increasing difficulty in maintaining their overhead. According to the Federal Reserve, small banks consistently outperformed large banks during the adverse period of 1977 to 1980. Small banks earned 29 percent of the income of the commercial banking system in 1980, although they held only 19 percent of assets. Their return on assets in 1980 was 1.19 percent, compared to 0.70 percent for large banks. This performance permitted small banks to reduce leverage while improving return on equity. Capital ratios at small banks rose 57 basis points to 8.39 percent during the 1977-80 period, while capital ratios for banks having assets of more than $1 billion declined 27 basis points to 4.55 percent. These far higher capital ratios put small banks in a much better position to withstand and adjust to economic adversity.

The IBAA would suggest that the Congress should be more concerned about whether large banks with lower capital ratios may not find themselves in severe difficulties if they are permitted to pursue highly leveraged branching and merger and acquisition strategies.

The provision of Federal deposit insurance means that the federal government ultimately stands behind and is liable when there are troubled depository institutions, be they large or small. We believe that the dual banking system

helps to assure the safety and soundness of the depository system, mitigates the impact of institutional failures, and reduces the risk that public funds may be required to assist troubled institutions.

The entry of nondepository and out-of-state financial institutions within a particular market in no way mitigates the increased concentration that will result at the national level if bank holding companies are permitted by an altered public policy to acquire thrifts, brokerage houses, etc. The major new nondepository competitors--the money market funds--have increased overall financial concentration by siphoning large amounts of capital out of small communities and into the commercial paper of money center banks. The MMMFs will continue to offer the retail customer a higher rate of return on deposits as long as the DIDC refuses to authorize banks to offer competitive instruments, but we know of no instance in which the retail customer has been able to obtain credit from a MMMF.

We do think that the separation of the loan function and the deposit-taking function has serious public policy implications. These two functions constitute the definition of a bank under the Bank Holding Company Act.

Again, we feel that the Banking Committees of the Congress should urgently explore whether certain activities such as the offering of transaction accounts should be limited to banks. In the future, it is our feeling that the resolution of this broader issue will have important ramifications, not only for the future of depository institutions but also for the conduct of monetary policy.

4. The length of the deliverative process is for Congress to decide. What we have attempted to point out in our testimony is that permitting the banking structure to be altered via the regulatory fiat inherent in a wave of assisted mergers would usurp the policymaking role of Congress, a situation we assume you would wish to forestall.

The level of interest rates over the coming months will set the length of time in which the thrift crisis can continue without additional substantial costs to the federal government. We believe the Congress should act immediately to enact a net worth stabilization plan, followed by expeditious determination of the most cost-effective means of dealing with the thrifts if interest rates remain high.

In 1980, the Congress enacted legislation which will result in total deregulation of interest rates paid by depository institutions in 1986. It is unlikely that interest rate ceilings will be totally deregulated before that date. In the interim transition period, costs to the economy and the taxpayer can be minimized through DIDC authorization of short-term competitive products with which depository institutions can compete with the MMMFs and other nonregulated financial institutions.

5. We believe that our testimony set out credible evidence that new mortgage instruments and utilization of the futures market can achieve the same end--reduction of interest rate risk--as the granting of commercial lending powers without weakening the specialized role of thrift institutions. We are enclosing an article, reproduced from the February 7, 1982, San Antonio Express News, which demonstrates that a thrift which is not burdened by a low-yielding mortgage portfolio can be highly profitable without resort to commercial banking powers. Highly responsible regulatory officials have also warned that according thrifts such powers could aggravate their short-term problems.

6. For those thrift institutions which believe that they must have commercial banking powers to survive, over the long haul, we believe that the Congress should provide an expedited procedure by which they may convert to a commercial bank charter. We will accept new competition on that basis. We cannot accept it from institutions with different capital requirements, different branching rules, preferential tax treatment, and the Congressional and regulatory fiat to offer more competitive Reg Q ceiling rates.

The IBAA does not believe that there is any basis in existing statutes for making governmental units eligible for NOW accounts. We would be opposed to making thrifts eligible to offer NOW accounts to state and local governments while denying that ability to commercial banks.

7. We have no doubt that poor management has contributed to the troubles of some thrift institutions. Such an institution would have difficulty demonstrating the reasonable prospect for long-term viability required by H R 5568. However, we believe that the overwhelming cause of the thrift crisis is that they have done their job of providing long-term mortgage finance too well against the backdrop of high and fluctuating interest rates, deposit deregulation and competition from money market mutual funds which play under very different regulatory rules of the game.

8. We believe that the Wharton study is highly accurate. Of course, its assumptions may be questioned, as can those of any econometric projection. However, it is important to note that, even when more positive economic scenarios are utilized by Wharton, the relative ranking of various assistance strategies remains the same, although the cost of each declines.

The IBAA does not have the facilities to subject the Wharton study to extensive scrutiny. The Congress however, does have the expertise of the Congressional Budget Office on tap, and we believe that it would be prudent to utilize that resource to review the Wharton study in view of the magnitude of expenditures at risk.

9.a. Testimony received from FHLBB Chairman Pratt, and from the U S League of Savings and Loan Associations indicates that up to 1,800 thrift institutions could be eligible for net worth stabilization assistance by the end of 1983, if interest rates do not decline significantly. We believe that eligibility could be readily determined by presentation of relevant financial records; and that limitations should not be placed upon management prerogatives except in those instances where mismanagement contributed significantly to an institution's problems and such limitations are required to assure continued viability.

The only suggested amendments to this program would be those we have outlined in answer #2, setting capital thresholds for participation by commercial banks with significant mortgage lending activity.

b. We believe that the quarterly reporting of financial condition and lending practices may be unduly burdensome while failing to provide information which significantly contributes to achieving the purpose of the legislation. We are unsure as to what information would be required, and suggest that the Committee consult with the regulatory agencies regarding the desirability and scope of this provision.

c. The amount of net new deposits will be determined both by public confidence in the response which Congress fashions to the thrift crisis and by the approval of competitive products by the DIDC. We are strongly opposed to mandated allocations of credit; and would suggest that, at a minimum the avenues of investment be broadened to include home improvement and rehabilitation loans, mortgage-backed securities, and multi-family mortgages. Because the average cost of funds is generally below the marginal cost of funds, this ceiling on loan rates could worsen the financial condition of assisted institutions it is our understanding that Chairman St Germain will be modifying this condition in response to repeated criticism it received during hearings. It would be most difficult for an institution to allocate funds among qualifying first-time homebuyers we have consistently suggested that homebuying assistance be considered separately from thrift assistance, as the former cannot be based upon participation of only the most troubled financial institutions and the latter is mandatory rather than discretionary in light of the risk exposure of the deposit insurance funds.

d. We believe it is sound public policy to provide for the type of net worth stabilization proposed in H.R. 5568. The provision and duration of net worth stabilization must be determined in accord with a decision as to how long capital infusion can substitute for actual cash outlays, be they due to assisted mergers, mortgage warehousing, or whatever. We agree that it would be most difficult for a regulatory agency to determine the underlying cause of continued earnings losses.

Inasmuch as Chairman St Germain has indicated that he will be reintroducing his bill to substitute a paper exchange method for cash loans, we would wish to withhold further comment on this provision until we have had an opportunity to review the revised legislation.

How an S&L gets ahead

by Thomas W. Lippman
Washington Post Service

CHRISTOPHER GILL can barely conceal his contempt for the managers of those venerable big-city savings and loan institutions that are facing record losses and possible insolvency.

His San Antonio-based Gill Savings is making money at an eye-opening rate and doubled its assets in 1981.

Gill Savings, a state-chartered, family-owned institution, claims to be the most profitable S&L in the country and the fastest-growing in Texas — a position it achieved by aggressive, innovative business tactics far removed from the S&L tradition.

When other S&Ls were "doing business by habit," Gill said, extending conventional home-mortgage loans and attracting small depositors, Gill Savings was financing commercial real estate ventures — taking equity positions in them — and bidding for the funds of depositors with more than $100,000 to invest.

"OVER $100,000, we can pay any interest rate we want," Gill explained, "and we do. If you have that much, we will beat the money market with our interest rates."

Many S&Ls that once were economic powerhouses in their communities have fallen on hard times because they hold large portfolios of long-term, low-yield home mortgages, once the cornerstone of their business.

The sustained nationwide high interest rates and the decline of the conventional mortgage market have undercut their profits, but Gill says it's the S&Ls' own fault for failing to respond to a changing real estate market.

"The real estate business is healthy," he said, "except for homebuilding. It's a very dynamic industry, especially in the Southwest. The S&Ls have what amounts to a monopoly right now to gather money from the public and channel it into real estate investment, so we ought to succeed. The government insures our business and limits access to it — that's a good deal."

THE MAIN REASON Gill Savings is not saddled with low-yield mortgages is that it has existed only since 1974.

Before that, it was the Richard Gill Co., an obscure mortgage banking business, starved for capital because it had no access either to federal mortgage seed money or to consumer deposits.

Denied a charter for its own S&L, Gill bought one, taking over the tiny Medina Savings Association, a $16-million blip on the finance charts based in Hondo.

That small institution became the foundation of Gill Savings, which according to Christopher Gill ended 1981 with assets of $300 million.

Texas Business magazine, a Dallas-based regional publication, says Gill Savings, a mortgage bank that acquired a savings and loan, has become a unique entity in the industry: "It is a savings and loan; San Antonio's largest mortgage servicer; a commercial lender for apartments, offices and shopping centers; a full-service home improvement and installment lender; a real estate appraisal firm; a commercial real estate broker, manager and developer; and a life insurance company."

THAT STRUCTURE comes close to achieving Gill's objective of being "a vertically integrated real estate organization, not just a renter of funds."

As a result, Christopher Gill said, Gill Savings will report about $5 million in earnings for 1981 — well over 100 percent of the $1.8 million in equity with which it began the year.

According to Gill, whose title is chief executive officer, and Edward Mattson, president, Gill Savings makes money from an activity that many other S&Ls try to avoid: servicing of mortgages, the processing of paper and the collection of mortgage payments.

"We originate loans and sell them and retain the servicing, and we buy loans from others, sell them and retain the servicing," Mattson said. "Servicing is a very substantial component of our business," with a total portfolio that grew from $634 million to $1.2 billion over the past year.

THE HEAD of Gill's real estate division is John H. Dalton, former chairman of the Federal Home Loan Bank Board. His division is critical to the profitability of the business, because the great majority of Gill's loans are made for commercial real estate ventures such as apartments and shopping centers.

The S&L insulates itself against interest fluctuations and inflation either by taking an equity position — buying a piece of the property itself — or by indexing the loan interest rate, tying it to some standard like the prime rate or a money market rate to avoid being caught by events with an unprofitable long-term set rate.

AS A RESULT, Gill said, "we earn more so we can pay more. We concentrate on the nonregulated segments of the deposit markets and we grow as we have dollars to invest. The earnings create capital and reserves and the ability to grow rapidly."

Christopher Gill

Gill, the son of founder Richard Gill, loves to talk about his business and is hardly diffident about its money-making potential.

He said that in the next five years he hopes Gill Savings will grow to a $1 billion institution and move up from about 20th in size among Texas S&Ls to the top five.

That prospect is "very exciting," he said, and "the S&L industry that is going to emerge from this shakeout is going to be strong and tough."

Chairman GONZALEZ. Thank you again. The subcommittee stands in recess until tomorrow morning at 10 in this same hearing room.

[Whereupon, at 6:45 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Thursday, April 1, 1982.]

HOUSING AND URBAN-RURAL RECOVERY ACT OF 1982

THURSDAY, APRIL 1, 1982

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez (chairman of the subcommittee) presiding.

Present: Representatives Gonzalez, St Germain, LaFalce, Lundine, Vento, Mitchell, Schumer, Wylie, McKinney, Wortley, Carman, McCollum, Lowery, and Bereuter.

Also present: Representative Emerson.

Chairman GONZALEZ. The subcommittee will please come to order. Our purpose this morning is to hear from the administration its views and recommendations on housing and community development programs for fiscal year 1983.

Perhaps it might be more correct to say "nonrecommendations" or "antirecommendations" in light of the President's statement a couple of days ago that he opposes any of what he called billion dollar bailouts for the housing industry.

So far as I can see, he is only willing to consider allowing realtors to take kickbacks on title insurance by repealing RESPA and maybe to consider a new tax gimmick or two. The problem with kickbacks is that they are reprehensible. They are prohibited by the ethics of realtors themselves, not to mention being plain old-fashioned crooked.

It is astonishing that the administration responds to a disaster in the housing industry by saying "let them have kickbacks," which is not unlike the earlier royal sentiment: "Let them eat cake." A new program of kickbacks won't do anything for housing.

We need a national housing commitment. We have said that repeatedly since last year.

We need it because there is, and for the foreseeable future there will be, a vast unmet need for housing. It is not only the poor who are shut out of the housing market today, it is everybody but the very well-off and the rich.

We need a housing program because there are three million people in the construction industry who are out of work. The cost of that unemployment in terms of lost revenue and added Government outlays for compensation benefits vastly outweighs the cost of

a housing stimulus program. It is far less expensive for the Nation to solve the housing crisis than it is for it to do nothing.

We need a housing program because the fundamental contradiction in the administration's economic program seems destined to ordain an indefinite future of stratospheric interest rates. This can only spell a long depression in housing, a depression that will breed deepening social and economic chaos.

We need a housing program because no nation, this or any other, has ever met its housing needs without a firm national commitment. I know that the theologians of the supply side believe that housing should have no favored position and homeowners should compete for credit with Exxon and General Motors, but we know they cannot.

Tax gimmicks and exhortations that prosperity lies just around the Laffer curve simply cannot solve the housing problems of the poor and will not do much for the needs of the middle class, either, which in our country are the majority.

This year, as I have said many times, we have to decide the fundamental question of whether or not we will have a national housing program, whether we will keep our commitment to housing or abandon it.

This year we have to decide whether we are going to preserve the housing industry or consign it to slide into oblivion. This year the administration has to decide whether or not to adopt a positive economic program or to stand by its economic fairy tales.

What we have heard so far this year is that the administration is not even willing to support the program levels that it supported last year, notwithstanding the fact that housing construction is at its lowest level since statistics on it have been available.

So far this year the administration has been unwilling even to respond to any suggestions about improving the condition of the housing industry. So far the administration has been unwilling to say that anything should be done about this disaster.

These are difficult days, and they require more of us than just standing pat. I hope, Mr. Secretary, that you will bring us some sign that the administration is ready to work toward a solution to the housing disaster, especially since there is every sign that the situation is getting worse, not better.

[The full text of Chairman Gonzalez' opening statement follows:]

OPENING REMARKS FOR CHAIRMAN HENRY B. GONZALEZ AT HOUSING SUBCOMMITTEE HEARING - APRIL 1, 1982

Secretary Pierce, welcome once again.

Our purpose today is to hear the views and recommendations of the Administration on housing and community development programs for the fiscal year 1983.

It might be more correct to say "non-recommendations" or "anti-recommendations" in light of the President's statement earlier this week that he opposes any of what he called billion dollar bailouts for the housing industry. So far as I can see, he is only willing to consider allowing realtors to take kickbacks on title insurance by repealing RESPA, and maybe to consider a new tax gimmick or two.

The problem with kickbacks is that they are reprehensible, and they are also prohibited by the ethics of realtors themselves -- not to mention being plain old fashioned crooked. It is astonishing that the Administration responds to a disaster in the housing industry by saying, "Let them have kickbacks," which is not unlike earlier royal sentiments like "Let them eat cake." A new program of kickbacks won't do anything for housing.

We need a national housing commitment.

We need it because there is, and for the forseeable future will be, a vast unmet need for housing. It is not only the poor who are shut out of the housing market today: it is everybody but the rich.

We need a housing program because there are three million people in the construction industry who are out of work. The cost of that unemployment in terms of lost revenue and added government outlays for compensation benefits vastly outweighs the cost of any housing stimulus program. It is far less expensive to solve the housing crisis than it is to do nothing.

We need a housing program because the fundamental contradiction in the Administrations's economic program seems destined to ordain an indefinite future of stratospheric interest rates. This can only spell a long depression in housing, a depression that will breed deepening social and economic chaos.

We need a housing program because no nation -- not this or any other -- has ever met its housing needs without a firm national commitment. I know that the theologians of the supply side believe that housing should have no favored position, and that homeowners should compete for credit with Exxon and General Motors -- but they cannot do so. Tax gimmicks and exhortations that prosperity lies just around the Laffer Curve simply cannot solve the housing problems of the poor, and will not do much for the needs of the middle class either.

This year -- and I have said this many times -- we have to decide the fundamental question of whether or not we will have a national housing program, whether we will keep our commitment to housing or see it abandoned.

This year we have to decide whether we are going to preserve the housing industry or consign it to slide into oblivion.

This year the Administration has to decide whether or not to auopt a positive economic program or to stand by its economic fairy tales.

What we have heard so far this year is that the Administration is not even willing to support the program levels that it supported last year -- notwithstanding the fact that housing construction is at its lowest level since statistics began to be kept. So far this year, the Administration has been unwilling even to respond to any suggestions about improving the condition of the housing industry. So far, the Administration has been wwilling to say that anything should be done about this disaster.

These are difficult days, and they require more of us than standing pat. I hope, Mr. Secretary, that you will bring us some sign that the Administration is ready to work toward a solution to the housing disaster, especially since there is every sign that the situation is getting worse, not better.

Chairman Gonzalez. Mr. Wylie, we recognize you.

Mr. Wylie. I don't have a prepared opening statement and wasn't going to offer one.

I feel that it does not add to the objective deliberations of this subcommittee when you make an unfortunate statement and leave the wrong impression that the President had mentioned something about kickbacks with respect to the title companies.

He never mentioned the word kickback. He did suggest the elimination of the controlled business restraints, which is far different. To eliminate some of the regulations, to assist realtors in the sale of property, and to eliminate some of the rules and regulations on savings and loans would be, of course, a big help.

I do feel, honestly, Mr. Chairman, that it is ludicrous to suggest that the President has recommended some form of kickback. I personally resent the suggestion.

Thank you.

Chairman Gonzalez. Well, it is not my intention to get into an argument about this, but I think there is no question, my esteemed colleague, as to what the President meant. Even the realtors themselves have had to come out and deny that this is what they are seeking.

It may be that you have the potential at this time to explain the President's words and in the absence of some more direct explanation of his remarks, I have no rejoinder but to say that your interpretation is different than mine.

Mr. Wylie. Mr. Chairman, I think maybe we ought to go to the Secretary and let him talk on this subject. This whole fuss has been in response to an article that was published in the Post that used the word "kickback" in quotes. It made reference to the statement by the President before the realtors. But, I think it would be better for the Secretary to clear that up.

Chairman Gonzalez. Well, I accept that and we will certainly give the Secretary an opportunity to clear it up.

We recognize the chairman of the full committee because these hearings, by the way, Mr. Secretary, include consideration of two bills. Jurisdiction for one of the bills before us is shared by this subcommittee and the subcommittee that over which the distinguished committee chairman presides.

Mr. St Germain. I appreciate it.

I want to make an observation here in response to Mr. Wylie's concern about the use of the word "kickback" by the press. You don't like it. You know what? I don't like people referring to my legislation as a bailout. If you agree with me you won't refer to my bill as a bailout, I won't refer to this as a kickback. [Laughter.]

Mr. Wylie. I don't believe I have ever referred to your legislation as a bailout.

Mr. St Germain. As you know, some have. So, if you will help me out on that, I will help you.

Mr. Carman. We certainly have a lot of leaky boat problems.

Mr. St Germain. I also welcome the Secretary. We look forward to hearing from you.

Chairman Gonzalez. We still have the Washington Post and Jimmy Carter to kick around.

Mr. WYLIE. I would say both are very deserving, Mr. Chairman. [Laughter.]

Mr. MITCHELL. Could we proceed with the hearing?

Chairman GONZALEZ. We will recognize you briefly.

Mr. MITCHELL. I thought it might be nice to hear the erudite wisdom of the Secretary rather than engage in this chitchat. I know he is under time constraints.

Chairman GONZALEZ. Mr. Secretary?

STATEMENT OF HON. SAMUEL R. PIERCE, JR., SECRETARY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary PIERCE. Yes, Mr. Chairman.

What I would like to do is to make some comments and then produce a more detailed statement for the record.

Chairman GONZALEZ. Certainly. Without objection, so ordered.

Secretary PIERCE. I am pleased to appear before this committee to discuss HUD's fiscal year 1983 legislative program and the future direction of Federal support of community development and housing.

The Department's 1983 program reflects a marked departure from the past and proposes a major redirection in the approach of the Federal Government to housing and urban development.

We believe significant changes must be made in the way housing programs operate and in the ways they are funded if the Federal Government is to continue to meet the objective of assisting those who need such support. Our program, therefore, proposes fundamental shifts in the policies followed by this Department for the past two decades.

My statement for the record describes our program in some detail. Before summarizing our major proposals, I would like to put into context the approach we are taking as it relates to the economic goals of this administration.

A primary goal of the administration is to bring inflation and the high interest rates of the past several years under control. Unless we end this inflationary spiral and place our Government on a sound economic footing, we face a disastrous future.

Double-digit inflation and high interest rates have taken their toll on all of us. In the housing industry, this has been reflected dramatically in soaring housing costs which have priced most Americans out of the home buying market and has caused severe hardships for those whose livelihood depends on a healthy shelter industry.

The harshest burden has fallen on those low-income families for whom achievement of the goal of decent, safe, and sanitary dwellings has become increasingly difficult.

The administration's program for economic recovery has only begun, and it will take time for the Nation to realize its beneifts. As inflation and interest rates are brought under control, the housing industry should prosper, as it has in the past, when interest rates were lower and more stable. Restoration of a healthy economic environment will improve the ability of all groups in our to find decent housing at affordable prices and rents.

The Department's fiscal year 1983 program and $3.5 billion budget level for the community development block grant program reflects the importance the administration places on economically and socially viable communities.

The Department is not proposing legislative amendments to the community development block grant program this year. However, we have made substantial progress in implementing the 1981 amendments, especially in the small cities programs, as described in my statement for the record.

We are proposing to continue the urban development action grant program at the same funding level as in 1982. Our recently completed evaluation concluded that UDAG is substantially fulfilling its congressional mandate and that, for the most part, UDAG projects are living up to the private investment and job creation that was originally anticipated. We are also proposing to expand the urban homesteading approach to demonstrate how it can be applied to HUD-held multifamily properties.

Our community development initiative this year includes two major proposals—the administration's enterprise zones plan announced by the President last week and a new rental rehabilitation program to help preserve and upgrade the Nation's rental housing stock.

Both of these initiatives will involve State, local, and private sector participation in upgrading and revitalizing our cities and neighborhoods.

Last year the Department worked closely with the Congress to address the high costs of housing programs and reduce the inequities and inefficiencies that had developed over the years. We have made progress in these areas.

This year the administration is proposing significant changes in the direction of subsidized housing programs. Perhaps the most important aspect of our fiscal year 1983 assisted housing program is the shift away from long-term subsidies for new construction and our emphasis on the use of existing housing stock.

We are proposing to cease offering new commitments for the very expensive section 8 new construction/substantial rehabilitation program and the public housing development program.

In their place we will rely more heavily on less expensive and more flexible kinds of subsidies to assist low-income families. The only exception to this general strategy is the section 202 program for the elderly and handicapped.

Simply stated, our present production programs are too costly, provide too large a subsidy for too few people, and are at best an indirect way of addressing the basic housing problem confronting lower-income families. In most localities, the problem is not a lack of adequate housing resources but rather a lack of adequate family income.

To achieve our proposed change of program direction from costly, long-term commitments, we are proposing a new component—a "Modified Certificate"—under the section 8 program.

We expect the certificate to become the cornerstone of HUD's future assistance to the truly needy. Our proposal is based upon experience from the 10-year experimental housing allowance program and the successful section 8 existing program.

The modified certificate program is designed to provide flexibility for participating families and to encourage households to shop for less expensive units and negotiate for lower rents. It will also provide families with increased opportunities to improve their housing by allowing them to choose from a wider range of units.

In public housing, as in section 8, we are proposing not to offer commitments for new construction. Instead, we will focus on improving the physical condition and upgrading the management and operation of existing public housing projects to assure their long-term viability.

The Department's fiscal year 1983 program anticipates continuation of the phasein of rent increases for subsidized housing tenants. This will be coupled with an administration initiative to take food stamps into account in determining tenant income and an amendment for an overall 20-percent cap on rent increases attributable to certain legislative changes.

Even with the proposed changes in this area, the rent burden for tenants who receive Federal assistance will continue to be significantly lower than for low-income families who do not receive such assistance.

Our legislative proposals for FHA are directed to three primary objectives: We propose, first, to direct FHA's single-family programs to home buyers unserved or underserved by the private sector; second, to modernize FHA programs to meet the changing requirements of the marketplace; and third, to increase housing affordability to achieve cost savings at HUD.

We think first-time and inner city home buyers is an appropriate role for FHA and we are proposing means of facilitating credit to these users, including limited authority to insure various alternative mortgage instruments.

GNMA pioneered the development of the secondary market for mortgage financing through the mortgage-backed securities program. We propose continuation of this program, at a level of $38.4 billion. The level proposed this year reflects a more realistic assessment of the amount of credit required to meet program demand in the current economic environment.

By putting this limit on GNMA, we intend to send to the market a signal that there is ample room for private alternatives to grow and prosper. We will continue to support the market, but we are looking to private firms to play an increasingly important role in the future.

We are not proposing any further funding for the GNMA tandem mortgage purchase program. This program has turned out to be much more expensive than originally contemplated and the effects often have not been focused on the truly needy.

The program changes and new directions being undertaken by this Department are important and necessary steps in reorienting Federal resources that no longer can be regarded as unlimited. We believe these scarce resources should be directed, in the words of the President's Housing Commission, "toward people, rather than toward structures."

For the past year this administration has worked diligently to develop a more rational and economically viable approach to the problem of providing shelter for the Nation's poor and to attack

the serious long-term budgetary problems created by the section 8 program. We believe these proposals are cost effective and needed and, above all, are fair and equitable. I urge this committee and the Congress to consider them fully.

[The following material was submitted for inclusion at this point: Secretary Pierce's summary statement and his prepared statement, both on behalf of the Department of Housing and Urban Development; a letter to the Speaker of the House Thomas P. O'Neill, Jr., with enclosed copy of Mr. Stanton's introduced bill, H.R. 6020; and a section-by-section explanation and justification of the bill. The material follows:]

SUMMARY STATEMENT OF

SAMUEL R. PIERCE, JR.

SECRETARY OF THE

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND

URBAN AFFAIRS

THURSDAY, APRIL 1, 1982

I am pleased to appear before this Committee to discuss HUD's Fiscal Year 1983 legislative program and the future direction of Federal support of community development and housing.

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We believe significant changes must be made in the way housing programs operate and in the ways they are funded if the Federal Government is to continue to meet the objective of assisting those who most need such support. Our program, therefore, proposes fundamental shifts in the policies followed by this Department for the past two decades.

My statement for the record describes our program in some detail. Before summarizing our major proposals, I would like to put into context the approach we are taking as it relates to the economic goals of this Administration. A primary goal of the Administration is to bring inflation and the high interest rates of the past several years under control. Unless we end this inflationary spiral and place our government on a sound economic footing, we face a disastrous future.

Double-digit inflation and high interest rates have taken their toll on all of us. In the housing industry, this has been reflected dramatically in soaring housing costs which have priced

MOST AMERICANS OUT OF THE HOMEBUYING MARKET, AND HAS CAUSED SEVERE HARDSHIPS FOR THOSE WHOSE LIVELIHOOD DEPENDS ON A HEALTHY SHELTER INDUSTRY. THE HARSHEST BURDEN HAS FALLEN ON THOSE LOW-INCOME FAMILIES FOR WHOM ACHIEVEMENT OF THE GOAL OF DECENT, SAFE AND SANITARY DWELLINGS HAS BECOME INCREASINGLY DIFFICULT.

THE ADMINISTRATION'S PROGRAM FOR ECONOMIC RECOVERY HAS ONLY BEGUN, AND IT WILL TAKE TIME FOR THE NATION TO REALIZE ITS BENEFITS. AS INFLATION AND INTEREST RATES ARE BROUGHT UNDER CONTROL, THE HOUSING INDUSTRY SHOULD PROSPER AS IT HAS IN THE PAST WHEN INTEREST RATES WERE LOWER AND MORE STABLE. RESTORATION OF A HEALTHY ECONOMIC ENVIRONMENT WILL IMPROVE THE ABILITY OF ALL GROUPS IN OUR SOCIETY TO FIND DECENT HOUSING AT AFFORDABLE PRICES AND RENTS.

COMMUNITY DEVELOPMENT

THE DEPARTMENT'S FY 1983 PROGRAM AND $3.5 BILLION BUDGET LEVEL FOR THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM REFLECTS THE IMPORTANCE THE ADMINISTRATION PLACES ON ECONOMICALLY AND SOCIALLY VIABLE COMMUNITIES. THE DEPARTMENT IS NOT PROPOSING LEGISLATIVE AMENDMENTS TO THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM THIS YEAR. HOWEVER, WE HAVE MADE SUBSTANTIAL PROGRESS IN IMPLEMENTING THE 1981 AMENDMENTS, ESPECIALLY IN THE SMALL CITIES PROGRAMS, AS DESCRIBED IN MY STATEMENT FOR THE RECORD.

We are proposing to continue the Urban Development Action Grant (UDAG) Program at the same funding level as in 1982. Our recently completed evaluation concluded that UDAG is substantially fulfilling its Congressional mandate and that, for the most part, UDAG projects are living up to the private investment and job creation that was originally anticipated. We are also proposing to expand the urban homesteading approach to demonstrate how it can be applied to HUD-held multifamily properties.

Our community development initiative this year includes two major proposals -- the Administration's Enterprise Zones plan announced by the President last week, and a new rental rehabilitation program to help preserve and upgrade the Nation's rental housing stock. Both of these initiatives will involve State, local and private sector participation in upgrading and revitalizing our cities and neighborhoods.

Housing Assistance Programs

Last year, the Department worked closely with the Congress to address the high costs of housing programs and reduce the inequities and inefficiencies that had developed over the years. We have made progress in these areas.

This year the Administration is proposing significant changes in the direction of subsidized housing programs. Perhaps the most important aspect of our FY 1983 assisted housing program is the shift away from long-term subsidies for new construction, and our emphasis on the use of existing housing stock.

We are proposing to cease offering new commitments for the very expensive Section 8 new construction/substantial rehabilitation program and the public housing development program. In their place, we will rely more heavily on less expensive and more flexible kinds of subsidies to assist lower-income families. The only exception to this general strategy is the Section 202 program for the elderly and handicapped.

Simply stated, our present production programs are too costly, provide too large a subsidy for too few people, and are at best an indirect way of addressing the basic housing problem confronting lower-income families. In most localities, the problem is not a lack of adequate housing resources, but rather, a lack of adequate family income.

To achieve our proposed change of program direction from costly, long-term commitments, we are proposing a new component -- a "Modified Certificate" -- under the Section 8 Existing

HOUSING ASSISTANCE PROGRAM. WE EXPECT THE CERTIFICATE TO BECOME THE CORNERSTONE OF HUD'S FUTURE ASSISTANCE TO THE TRULY NEEDY. OUR PROPOSAL IS BASED UPON EXPERIENCE FROM THE 10-YEAR EXPERIMENTAL HOUSING ALLOWANCE PROGRAM AND THE SUCCESSFUL SECTION 8 EXISTING PROGRAM.

THE MODIFIED CERTIFICATE PROGRAM IS DESIGNED TO PROVIDE FLEXIBILITY FOR PARTICIPATING FAMILIES, AND TO ENCOURAGE HOUSEHOLDS TO SHOP FOR LESS EXPENSIVE UNITS AND NEGOTIATE FOR LOWER RENTS. IT ALSO WILL PROVIDE FAMILIES WITH INCREASED OPPORTUNITIES TO IMPROVE THEIR HOUSING BY ALLOWING THEM TO CHOOSE FROM A WIDER RANGE OF UNITS.

IN PUBLIC HOUSING, AS IN SECTION 8, WE ARE PROPOSING NOT TO OFFER COMMITMENTS FOR NEW CONSTRUCTION. INSTEAD, WE WILL FOCUS ON IMPROVING THE PHYSICAL CONDITION AND UPGRADING THE MANAGEMENT AND OPERATION OF EXISTING PUBLIC HOUSING PROJECTS TO ASSURE THEIR LONG-TERM VIABILITY.

THE DEPARTMENT'S FY 1983 PROGRAM ANTICIPATES CONTINUATION OF THE PHASE-IN OF RENT INCREASES FOR SUBSIDIZED HOUSING TENANTS. THIS WILL BE COUPLED WITH AN ADMINISTRATION INITIATIVE TO TAKE FOOD STAMPS INTO ACCOUNT IN DETERMINING TENANT INCOME AND AN AMENDMENT FOR AN OVERALL 20% CAP ON RENT INCREASES ATTRIBUTABLE TO CERTAIN LEGISLATIVE CHANGES.

Even with the proposed changes in this area, the rent burden for tenants who receive Federal assistance will continue to be significantly lower than for low-income families who do not receive such assistance.

New Directions for FHA

Our legislative proposals for FHA are directed to three primary objectives. We propose, first, to direct FHA's single-family programs to homebuyers unserved or underserved by the private sector; second, to modernize FHA programs to meet the changing requirements of the marketplace; and third, to increase housing affordability and achieve cost savings at HUD.

We think serving first-time and inner city homebuyers is an appropriate role for FHA and we are proposing means of facilitating credit to these users, including limited authority to insure various alternative mortgage instruments.

Government National Mortgage Association (GNMA)

GNMA pioneered the development of the secondary market for mortgage financing through the mortgage-backed securities program. We propose continuation of this program, at a level of $38.4 billion. The level proposed this year reflects a more

REALISTIC ASSESSMENT OF THE AMOUNT OF CREDIT REQUIRED TO MEET PROGRAM DEMAND IN THE CURRENT ECONOMIC ENVIRONMENT.

BY PUTTING THIS LIMIT ON GNMA, WE INTEND TO SEND TO THE MARKET A SIGNAL THAT THERE IS AMPLE ROOM FOR PRIVATE ALTERNATIVES TO GROW AND PROSPER. WE WILL CONTINUE TO SUPPORT THE MARKET, BUT WE ARE LOOKING TO PRIVATE FIRMS TO PLAY AN INCREASINGLY IMPORTANT ROLE IN THE FUTURE.

WE ARE NOT PROPOSING ANY FURTHER FUNDING FOR THE GNMA TANDEM MORTGAGE PURCHASE PROGRAM. THIS PROGRAM HAS TURNED OUT TO BE MUCH MORE EXPENSIVE THAN ORIGINALLY CONTEMPLATED AND THE EFFECTS OFTEN HAVE NOT BEEN FOCUSED ON THE TRULY NEEDY.

CONCLUSION

THE PROGRAM CHANGES AND NEW DIRECTIONS BEING UNDERTAKEN BY THIS DEPARTMENT ARE IMPORTANT AND NECESSARY STEPS IN REORIENTING FEDERAL RESOURCES THAT NO LONGER CAN BE REGARDED AS UNLIMITED. WE BELIEVE THESE SCARCE RESOURCES SHOULD BE DIRECTED "TOWARD PEOPLE, RATHER THAN TOWARD STRUCTURES," IN THE WORDS OF THE PRESIDENT'S HOUSING COMMISSION.

FOR THE PAST YEAR, THIS ADMINISTRATION HAS WORKED DILIGENTLY TO DEVELOP A MORE RATIONAL AND ECONOMICALLY VIABLE APPROACH TO THE PROBLEM OF PROVIDING SHELTER FOR THE NATION'S POOR AND TO ATTACK THE SERIOUS LONG-TERM BUDGETARY PROBLEMS CREATED BY THE SECTION 8 PROGRAM. WE BELIEVE THESE PROPOSALS ARE COST-EFFECTIVE AND NEEDED, AND, ABOVE ALL, ARE FAIR AND EQUITABLE. I URGE THIS COMMITTEE AND THE CONGRESS TO CONSIDER THEM CAREFULLY.

STATEMENT OF

SAMUEL R. PIERCE, JR.

SECRETARY OF THE

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND

URBAN AFFAIRS

APRIL 1, 1982

I am pleased to appear before this Committee to discuss HUD's fiscal year 1983 Legislative program and the future direction of Federal support of community development and housing.

The Department's 1983 program reflects a marked departure from the past and proposes a major redirection in the approach of the Federal Government to housing and urban development.

We believe significant changes must be made in the way housing programs operate and in the ways they are funded if the Federal Government is to continue to meet the objective of assisting those who most need such support. Our program, therefore, proposes fundamental shifts in the policies followed by this Department for the past two decades.

My statement will describe our program in some detail. First, however, I would like to put into context the approach we are taking as it relates to the major economic goals of this Administration. A primary goal of the Administration is to bring inflation and the high interest rates of the past several years

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UNDER CONTROL. UNLESS WE END THIS INFLATIONARY SPIRAL AND PLACE OUR GOVERNMENT ON A SOUND ECONOMIC FOOTING, WE FACE A DISASTROUS FUTURE.

THE PROGRAM PROPOSED BY THE PRESIDENT AND SUPPORTED BY THE CONGRESS--A SUBSTANTIAL REDUCTION IN THE GROWTH OF FEDERAL SPENDING, A 25 PERCENT CUT IN THE FEDERAL TAX BURDEN DURING THE NEXT THREE YEARS, THE PRUDENT ELIMINATION OF EXCESSIVE REGULATION, AND DEVELOPMENT OF A MONETARY POLICY GEARED TO STABILIZE AND REVITALIZE THE ECONOMY--IS ABSOLUTELY NECESSARY IF WE ARE TO SUCCEED.

DOUBLE-DIGIT INFLATION AND HIGH INTEREST RATES HAVE TAKEN THEIR TOLL ON ALL OF US. IN THE HOUSING INDUSTRY, THIS HAS BEEN REFLECTED DRAMATICALLY IN SOARING HOUSING COSTS WHICH HAVE PRICED MOST AMERICANS OUT OF THE HOMEBUYING MARKET, AND HAS CAUSED SEVERE HARDSHIPS FOR MANY HOMEBUILDERS, REAL ESTATE AGENTS, CONSTRUCTION WORKERS, AND OTHER AMERICANS WHOSE LIVELIHOOD DEPENDS ON A HEALTHY SHELTER INDUSTRY. THE HARSHEST BURDEN HAS FALLEN ON THOSE LOW-INCOME FAMILIES FOR WHOM ACHIEVEMENT OF THE GOAL OF DECENT, SAFE AND SANITARY DWELLINGS HAS BECOME INCREASINGLY DIFFICULT.

The Administration's program for economic recovery has only begun, and it will take time for the Nation to realize its benefits. As inflation and interest rates are brought under control, the housing industry should prosper as it has in the past when interest rates were lower and more stable. Restoration of a healthy economic environment will improve the ability of all groups in our society to find decent housing at affordable prices and rents.

Community Development

The Department's FY 1983 program and \$3.5 billion budget level for the Community Development Block Grant Program reflects the importance the Administration places on economically and socially viable communities. Although the Department is not proposing legislative amendments to the Community Development Block Grant program this year, I would like to report to you on the progress we have made thus far in implementing the 1981 amendments, especially in the small cities program.

The response of States across the country to the opportunity to determine how to distribute over \$1 billion in community development funds has been gratifying. We anticipate that up to

36 STATES WILL EXERCISE THEIR OPTION UNDER THE LEGISLATION TO ADMINISTER THE PROGRAM IN FISCAL YEAR 1982, AND ANOTHER 10 TO 12 WILL ASSUME RESPONSIBILITY IN FISCAL YEAR 1983.

THE SCOPE OF THE CONSULTATION AND HEARING PROCESS THAT HAS BEEN CARRIED OUT THUS FAR HAS EXCEEDED OUR EXPECTATIONS. MANY STATES HAVE FORMED COMMITTEES OR TASK FORCES, CONSISTING OF ELECTED LOCAL OFFICIALS AND COMMUNITY DEVELOPMENT PRACTITIONERS, TO ADVISE ON THE MOST APPROPRIATE MEANS OF IMPLEMENTING STATE-RUN COMMUNITY DEVELOPMENT PROGRAMS.

THE RESULT HAS BEEN THE DEVELOPMENT OF A WIDE VARIETY OF STATE PROGRAMS. SOME PROGRAMS ARE EMPHASIZING HOUSING, OTHERS FOCUS ON PUBLIC FACILITIES TO DEAL WITH THE SHORTAGE OF ADEQUATE WATER AND SEWER FACILITIES, PARTICULARLY IN SMALL RURAL COMMUNITIES AND COUNTIES, AND MANY ARE EMPHASIZING ECONOMIC DEVELOPMENT TO CREATE OR RETAIN JOBS FOR RESIDENTS OF THESE AREAS.

WE ARE CONFIDENT THESE STATE PROGRAMS WILL REFLECT THE OBJECTIVES OF THE 1981 AMENDMENTS AND WILL RESULT IN THE USE OF COMMUNITY DEVELOPMENT FUNDS IN A MANNER CONSISTENT WITH STATE AND LOCAL NEEDS.

We have conducted design and implementation forums in 25 States and will be conducting over the next few months a series of training sessions to acquaint States with the Federal requirements for which they will assume responsibility. Also, Section 107 Technical Assistance is available to those States expressing an interest in assuming responsibility for the program in either FY 1982 or 1983.

The Department will issue revised regulations for the HUD-Managed Small Cities Program within the next few weeks. Because the statute no longer requires an application or a Housing Assistance Plan, we will be able to implement a one-step application process, instead of the two-step process employed in the past for this program. The selection process will provide small cities considerably more flexibility in designing their programs.

Urban Development Action Grants

The FY 1983 Budget proposes to continue the Urban Development Action Grant (UDAG) Program at $440 million, the same funding level as in 1982. Last year I announced that an evaluation of the UDAG program would be carried out by our Office of Policy Development and Research. The evaluation team

CONDUCTED AN INTENSIVE EXAMINATION OF 80 ACTION GRANT PROJECTS IN 70 CITIES. THIS FIRST EVALUATION CONCLUDED THAT UDAG IS SUBSTANTIALLY FULFILLING ITS CONGRESSIONAL MANDATE, AND THAT, FOR THE MOST PART, UDAG PROJECTS ARE LIVING UP TO THE PRIVATE INVESTMENT AND JOB CREATION THAT WAS ORIGINALLY ANTICIPATED. THE STUDY ENABLED US TO MAKE SEVERAL CHANGES THAT WILL IMPROVE THE PROGRAM'S PERFORMANCE IN PROMOTING ECONOMIC DEVELOPMENT IN DISTRESSED CITIES AND URBAN COUNTIES.

NEW ACTION GRANT REGULATIONS INCORPORATING THE LEGISLATIVE PROVISIONS ENACTED LAST YEAR WERE PUBLISHED IN THE FEDERAL REGISTER ON FEBRUARY 23, 1982 WITH AN EFFECTIVE DATE OF MARCH 31. CONSISTENT WITH THE AMENDED STATUTE, THE UDAG PLANNING PROCESS HAS BEEN STREAMLINED SUBSTANTIALLY TO REDUCE TIME AND PAPERWORK BURDENS ON APPLICANTS. WE HAVE INCORPORATED THE NEW PROVISION THAT THE UDAG SUBSIDY BE THE LEAST AMOUNT REQUIRED FOR THE PROJECT TO PROCEED, AND WE HAVE STRENGTHENED LANGUAGE TO INSURE THAT THE UDAG GRANT IS NOT USED AS A SUBSTITUTE FOR OTHER AVAILABLE NON-FEDERAL FUNDS.

THE REGULATIONS STIPULATE INCREASED EMPHASIS ON ECONOMIC RECOVERY AND IMPROVE OUR ABILITY TO RESPOND TO LOCAL PRIORITIES BY ELIMINATING THE REQUIREMENT THAT HUD FUND A REASONABLE BALANCE

AMONG COMMERCIAL, INDUSTRIAL, AND NEIGHBORHOOD PROJECTS. THOSE PROJECTS BEST IMPLEMENTING ECONOMIC RECOVERY GOALS -- LEVERAGING PRIVATE INVESTMENT AND PROVIDING JOBS AND TAXES IN DISTRESSED CITIES AND URBAN COUNTIES -- WILL RECEIVE PRIORITY.

ENTERPRISE ZONES

THE ADMINISTRATION IS PROPOSING SEVERAL NEW INITIATIVES THIS YEAR TO HELP REVITALIZE COMMUNITIES. A MAJOR INITIATIVE IS OUR PLAN FOR ENTERPRISE ZONES, AN EXPERIMENTAL FREE-MARKET PROGRAM FOR IMPROVING AND DEVELOPING DEPRESSED AREAS. THIS PROPOSAL WILL PERMIT STATES AND LOCALITIES TO APPLY TO THE FEDERAL GOVERNMENT FOR DESIGNATION AS ENTERPRISE ZONES AND IS CONSISTENT WITH THE ADMINISTRATION'S OBJECTIVE OF STRENGTHENING THE FLEXIBILITY OF STATE AND LOCAL GOVERNMENTS.

THE PURPOSE OF THE PROGRAM IS TWOFOLD: TO CREATE JOBS IN DEPRESSED URBAN AREAS AND RURAL TOWNS, PARTICULARLY JOBS FOR DISADVANTAGED WORKERS, AND TO REDEVELOP AND REVITALIZE THE GEOGRAPHIC ZONE AREAS.

THE ENTERPRISE ZONE CONCEPT RELIES ON MARKET PROCESSES--RATHER THAN FEDERAL SUBSIDIES AND CENTRAL PLANNING--BY

PROVIDING TAX RELIEF AND REDUCING REGULATIONS AT THE FEDERAL, STATE AND LOCAL LEVELS. IT IS ALSO DESIGNED TO ENCOURAGE IMPROVEMENTS IN LOCAL PUBLIC SERVICES AND INVOLVE PRIVATE, LOCAL AND NEIGHBORHOOD ORGANIZATIONS IN THE PROGRAM.

UNDER THE PROPOSED LEGISLATION, HUD WOULD BE AUTHORIZED TO APPROVE THE DESIGNATION OF AN AREA AS AN ENTERPRISE ZONE ON THE APPLICATION OF THE STATE AND LOCAL GOVERNMENTS, IF THE AREA MEETS ELIGIBILITY CRITERIA BASED ON POVERTY, UNEMPLOYMENT, AND OTHER MEASURES OF DISTRESS. UP TO 25 ZONES PER YEAR, FOR THREE YEARS, COULD BE SO DESIGNATED, ON A COMPETITIVE BASIS.

ALTHOUGH THERE WILL BE NO FEDERAL OUTLAYS FOR THE PROGRAM, THE TREASURY DEPARTMENT ESTIMATES THAT $310 MILLION IN TAX REVENUES WILL BE FOREGONE FOR 25 ENTERPRISE ZONES IN THE FIRST YEAR OF OPERATION. ASSUMING THE PROGRAM IS SUCCESSFUL IN STIMULATING ECONOMIC DEVELOPMENT AND EMPLOYING UNEMPLOYED RESOURCES, THIS REVENUE LOSS SHOULD BE SIGNIFICANTLY OFFSET BY THE GENERATION OF NEW REVENUES AND BY REDUCED GOVERNMENT EXPENDITURES DUE TO THE EMPLOYMENT OF INDIVIDUALS FORMERLY RECEIVING GOVERNMENT AID. THE COST OF THE PROGRAM SHOULD, THEREFORE, BE EVEN LESS.

Enterprise Zones offer great promise for improving the quality of life in distressed communities, and I hope Congress will give this proposal expeditious and favorable consideration.

Rental Rehabilitation Program

The Administration is also proposing a new rental rehabilitation program to help preserve and upgrade the Nation's rental housing stock. The new program will replace the Section 312 Rehabilitation Loan and Section 8 Moderate Rehabilitation programs.

The program will provide grant assistance of $150 million to local governments and States to support the rehabilitation of approximately 30,000 units. The grants will be used to subsidize the cost of rehabilitating properties for rental at competitive market rates.

This rehabilitation initiative will be linked to the new Modified Section 8 Certificate program. Under our proposal, 30,000 Modified Section 8 Certificates will be made available to States and localities carrying out rental rehabilitation programs. These certificates will be provided to eligible

TENANTS RESIDING IN UNITS TO BE REHABILITATED UNDER THE INITIATIVE. THE TENANTS WILL HAVE THE OPTION OF REMAINING IN THE UNITS AFTER REHABILITATION OR USING THE ASSISTANCE PROVIDED BY THE CERTIFICATES TO RESIDE IN OTHER DWELLINGS OF THEIR CHOICE.

THOSE CERTIFICATES AVAILABLE AS A RESULT OF TENANTS INELIGIBLE FOR ASSISTANCE RESIDING IN THE REHABILITATED UNITS COULD BE USED TO ASSIST OTHER ELIGIBLE FAMILIES IN THE LOCALITY. THE PROGRAM IS DESIGNED TO ENCOURAGE PARTICIPATING GOVERNMENTS TO INSURE THAT THE REHABILITATED UNITS BE AFFORDABLE AT MARKET RATES TO CERTIFICATE HOLDERS.

WE BELIEVE THIS PROGRAM WILL BE FAR MORE COST EFFECTIVE THAN PREVIOUS REHABILITATION EFFORTS AND WILL RESULT IN INCREASED PRIVATE SECTOR PARTICIPATION IN UPGRADING VALUABLE EXISTING HOUSING ASSETS.

URBAN HOMESTEADING

THE DEPARTMENT ALSO IS PROPOSING $12 MILLION IN 1983 TO CONTINUE AND EXPAND THE URBAN HOMESTEADING APPROACH TO HOUSING AND NEIGHBORHOOD REVITALIZATION. IN ADDITION TO THE HOMESTEADING OF SINGLE FAMILY PROPERTIES IN THE HUD INVENTORY, A DEMONSTRATION

PROGRAM IS PROPOSED FOR USE OF HUD-HELD MULTIFAMILY PROPERTIES FOR URBAN HOMESTEADING, SPECIFICALLY "CONDO-STEADING" AND "COOP-STEADING." WE INTEND TO EVALUATE THE EFFECTIVENESS OF THIS DEMONSTRATION IN REVITALIZING DISTRESSED NEIGHBORHOODS AND IN PROVIDING HOMEOWNERSHIP OPPORTUNITIES FOR MORE PEOPLE.

HOUSING ASSISTANCE PROGRAMS

LAST YEAR, THE DEPARTMENT WORKED CLOSELY WITH THE CONGRESS TO ADDRESS THE HIGH COSTS OF HOUSING PROGRAMS AND REDUCE THE INEQUITIES AND INEFFICIENCIES THAT HAD DEVELOPED OVER THE YEARS. WE HAVE MADE PROGRESS IN THESE AREAS.

DURING THE PAST YEAR, WE HAVE PROVIDED COST CONTAINMENT AND MODEST DESIGN REQUIREMENTS FOR THE SECTION 8 AND SECTION 202 PROGRAMS, AND WE HAVE DEVELOPED REGULATIONS FOR INCREASING THE PERCENTAGE OF TENANT INCOME PAID FOR RENT ON A FIVE-YEAR PHASED-IN BASIS. THESE EFFORTS WILL CONTINUE.

THIS YEAR THE ADMINISTRATION IS PROPOSING SIGNIFICANT CHANGES IN THE DIRECTION OF SUBSIDIZED HOUSING PROGRAMS. PERHAPS THE MOST IMPORTANT ASPECT OF OUR FY 1983 ASSISTED HOUSING PROGRAM IS THE SHIFT AWAY FROM LONG-TERM SUBSIDIES FOR NEW CONSTRUCTION, AND OUR EMPHASIS ON THE USE OF EXISTING HOUSING STOCK.

ELIMINATING COSTLY NEW PRODUCTION. THE ADMINISTRATION IS PROPOSING TO CEASE OFFERING NEW COMMITMENTS FOR THE VERY EXPENSIVE SECTION 8 NEW CONSTRUCTION/SUBSTANTIAL REHABILITATION PROGRAM AND THE PUBLIC HOUSING DEVELOPMENT PROGRAM. IN THEIR PLACE, WE WILL RELY MORE HEAVILY ON LESS EXPENSIVE AND MORE FLEXIBLE KINDS OF SUBSIDIES TO ASSIST LOWER-INCOME FAMILIES. THE ONLY EXCEPTION TO THIS GENERAL STRATEGY IS THE SECTION 202 PROGRAM FOR THE ELDERLY AND HANDICAPPED.

SIMPLY STATED, OUR PRESENT PRODUCTION PROGRAMS ARE TOO COSTLY, PROVIDE TOO LARGE A SUBSIDY FOR TOO FEW PEOPLE, AND ARE AT BEST AN INDIRECT WAY OF ADDRESSING THE BASIC HOUSING PROBLEM CONFRONTING LOWER-INCOME FAMILIES. IN MOST LOCALITIES, THE PROBLEM IS NOT A LACK OF ADEQUATE HOUSING RESOURCES, BUT RATHER, A LACK OF ADEQUATE FAMILY INCOME.

IN RECENT YEARS, TENANT RENT SUBSIDIES PAID TO THE DEVELOPERS OF NEW SECTION 8 PROJECTS HAVE BEEN RISING AT TWICE THE RATE OF INCREASE IN CONSTRUCTION COSTS. FOR EXAMPLE, SUBSIDIZED HOUSING OUTLAYS GREW FROM $2.9 BILLION IN 1978 TO $5.7 BILLION IN 1981, WHICH REFLECTS AN ANNUAL GROWTH RATE OF 24 PERCENT. BY THE END OF FISCAL YEAR 1981, COMMITMENTS FOR FUTURE HOUSING OUTLAYS TOTALED $236 BILLION. ANNUAL SUBSIDIES IN SOME

AREAS RANGE AS HIGH AS $17,000 PER UNIT, WITH UP TO A 30-YEAR COMMITMENT TO PROVIDE THIS LEVEL OF SUBSIDY. PUBLIC HOUSING IS ALSO EXPENSIVE, WITH DEVELOPMENT COSTS AVERAGING $63,000 PER UNIT. IT IS CLEAR THAT WE CAN NO LONGER AFFORD THE LUXURY OF PROVIDING RENTAL ASSISTANCE IN THE SAME WAY IT HAS BEEN FURNISHED IN RECENT YEARS.

THE DEPARTMENT HAS COMMITMENTS TO SUBSIDIZE SOME 300,000 SECTION 8 AND PUBLIC HOUSING UNITS THAT HAVE NOT BEGUN CONSTRUCTION. MANY OF THESE PROJECTS ARE NOT FINANCIALLY VIABLE AND ARE NOT MAKING PROGRESS TOWARD THE CONSTRUCTION PHASE. WHERE THIS IS THE CASE, WE WILL TAKE STEPS TO CANCEL THE COMMITMENTS AND USE THE DEOBLIGATED FUNDS TO CONDUCT OUR PROPOSED PROGRAM.

AT THE SAME TIME, I WANT TO MAKE IT CLEAR THAT WE INTEND TO HONOR SUBSIDY COMMITMENTS AND WILL CONTINUE TO PROCESS THOSE PROJECTS THAT ARE ABLE TO PROCEED TO CONSTRUCTION. AS A RESULT, WE EXPECT THE ADMINISTRATION'S PROGRAM TO INCREASE THE NUMBER OF SUBSIDIZED HOUSEHOLDS FROM 3.3 MILLION TO 3.8 MILLION BY THE END OF FISCAL YEAR 1985.

EMPHASIZING USE OF EXISTING STOCK: THE MODIFIED SECTION 8 EXISTING HOUSING ASSISTANCE PROGRAM. TO ACHIEVE OUR PROPOSED

CHANGE OF PROGRAM DIRECTION FROM COSTLY, LONG-TERM COMMITMENTS, WE ARE PROPOSING A NEW COMPONENT - A "MODIFIED CERTIFICATE"- UNDER THE SECTION 8 EXISTING HOUSING ASSISTANCE PROGRAM. WE EXPECT THE CERTIFICATE TO BECOME THE CORNERSTONE OF HUD'S FUTURE ASSISTANCE TO THE TRULY NEEDY. OUR PROPOSAL IS BASED UPON EXPERIENCE FROM THE 10-YEAR EXPERIMENTAL HOUSING ALLOWANCE PROGRAM AND THE SUCCESSFUL SECTION 8 EXISTING PROGRAM.

THE MODIFIED CERTIFICATE PROGRAM WILL BE STRUCTURED IN MUCH THE SAME WAY AS THE CURRENT SECTION 8 EXISTING CERTIFICATE PROGRAM WITH PAYMENTS CONTINUING TO GO DIRECTLY TO THE OWNER. HOWEVER, INSTEAD OF HAVING RENT "CAPPED" BY AN ESTABLISHED "FAIR MARKET RENT," AS IN THE CURRENT SECTION 8 EXISTING HOUSING PROGRAM, TENANTS WILL RECEIVE A SET SUBSIDY, BASED ON THEIR INCOME AND THE RELATIVE HOUSING COSTS IN THE AREA, TO APPLY TOWARD RENT IN UNITS OF THEIR CHOICE.

IF THE SUBSIDY RECIPIENTS FIND "BARGAINS" MEETING HOUSING QUALITY STANDARDS, THEY CAN RETAIN THE SAVINGS. IF THEY WANT TO SELECT MORE EXPENSIVE UNITS, THEY MUST PAY THE COST DIFFERENCE THEMSELVES.

THE MODIFIED CERTIFICATE PROGRAM IS DESIGNED TO PROVIDE FLEXIBILITY FOR PARTICIPATING FAMILIES, AND TO ENCOURAGE

HOUSEHOLDS TO SHOP FOR LESS EXPENSIVE UNITS AND NEGOTIATE FOR LOWER RENTS. IT ALSO WILL PROVIDE FAMILIES WITH INCREASED OPPORTUNITIES TO IMPROVE THEIR HOUSING BY ALLOWING THEM TO CHOOSE FROM A WIDER RANGE OF UNITS.

FOR FISCAL YEAR 1983, OUR BUDGET REQUEST ANTICIPATES 106,615 MODIFIED CERTIFICATES. THE BULK OF THESE WOULD ASSIST CONVERSIONS FROM THE REGULAR SECTION 8 EXISTING PROGRAM AS CURRENT COMMITMENTS WITH PUBLIC HOUSING AGENCIES EXPIRE. FUNDING WILL ALSO BE AVAILABLE FOR ASSISTED FAMILIES WHEN OWNERS OF SECTION 8 NEW CONSTRUCTION PROJECTS DO NOT RENEW THEIR SUBSIDY CONTRACTS, WHEN PUBLIC HOUSING PROJECTS ARE SOLD OR DEMOLISHED, OR WHEN FORMERLY-SUBSIDIZED HUD-OWNED PROJECTS ARE SOLD.

<u>HOUSING FOR THE ELDERLY</u>. THE ADMINISTRATION RECOGNIZES THE SPECIAL NEEDS INVOLVED IN PROVIDING HOUSING FOR THE ELDERLY AND HANDICAPPED--NEEDS WHICH OFTEN MUST BE MET THROUGH NEW CONSTRUCTION--AND PROPOSES CONTINUATION OF THE SECTION 202 DIRECT LOAN PROGRAM.

THE FY 1983 BUDGET LEVEL OF $453 MILLION IN LOAN AUTHORITY WILL ENABLE US TO MAKE COMMITMENTS FOR ABOUT 10,000 NEW UNITS FOR THE ELDERLY OR HANDICAPPED. WHILE THIS REPRESENTS A REDUCED

LEVEL FROM THE 17,000 UNIT RESERVATIONS WE EXPECT TO MAKE DURING FY 1982, WE ANTICIPATE NO SLACKENING IN THE PACE IN WHICH 202 UNITS ARE COMPLETED AND MADE AVAILABLE FOR OCCUPANCY. DUE TO LOAN COMMITMENTS MADE THIS YEAR AND IN PRIOR YEARS, WE EXPECT TO SEE A TOTAL OF 20,000 NEW UNITS MADE AVAILABLE FOR OCCUPANCY IN FY 1983, AND NEARLY 100,000 NEW UNITS MADE AVAILABLE OVER THE NEXT THREE YEARS.

IN ORDER TO ACHIEVE MAXIMUM BENEFIT FROM THE LOAN AUTHORITY ALREADY AVAILABLE, THE DEPARTMENT IS TAKING STEPS TO CANCEL PROJECTS WHICH HAVE BEEN IN THE PIPELINE FOR A LONG PERIOD OF TIME AND WHICH ARE NOT MAKING ANY PROGRESS TOWARD CONSTRUCTION.

IN ADDITION, WE ARE IMPLEMENTING REFORMS THIS YEAR THAT WILL ELIMINATE UNNECESSARY AMENITIES IN THESE PROJECTS, PERMIT COMPETITIVE BIDDING IN CONSTRUCTION, AND SUBJECT THE PROGRAM TO THE SAME COST CONTROLS AS OTHER FEDERALLY-ASSISTED HOUSING PROGRAMS. AS A RESULT, AND IN SPITE OF CONTINUING INFLATION, WE EXPECT TO ACHIEVE A DECREASE IN THE AVERAGE COST OF A COMPLETED UNIT FROM $48,300 TO $42,300 IN 1983.

EMPHASIZING MODERNIZATION OF PUBLIC HOUSING STOCK. UNTIL RECENTLY, THE BASIC APPROACH TO UPGRADING PUBLIC HOUSING WAS TO FINANCE PIECEMEAL PHYSICAL IMPROVEMENTS RATHER THAN ONE-TIME

SUBSTANTIAL REHABILITATION OF A PROJECT. THIS APPROACH WAS ADEQUATE FOR MOST PROJECTS REQUIRING ONLY SELECTED PHYSICAL IMPROVEMENTS, BUT WAS INADEQUATE FOR THOSE PROJECTS WITH SEVERAL PHYSICAL DEFICIENCIES.

WE PROPOSE TO FUND THE COMPREHENSIVE IMPROVEMENT ASSISTANCE, OR MODERNIZATION, PROGRAM IN FY 1982 AND 1983 AT A LEVEL OF $1.8 BILLION FOR EACH YEAR. THIS REPRESENTS AN INCREASE OF $100 MILLION OVER THE 1981 LEVEL OF $1.7 BILLION ACTUALLY USED. UNDER THIS PROGRAM, WE ARE PROVIDING FINANCIAL ASSISTANCE TO PUBLIC HOUSING AGENCIES (PHAS) TO IMPROVE THE PHYSICAL CONDITION AND UPGRADE THE MANAGEMENT AND OPERATION OF EXISTING PUBLIC HOUSING PROJECTS TO ASSURE THE LONG-TERM VIABILITY OF THE PROJECTS.

TO ASSIST IN FINANCING THIS PROGRAM WE PROPOSE TO OFFER LOCAL AUTHORITIES THE OPTION OF CANCELLING OUTSTANDING RESERVATIONS FOR CONSTRUCTION OF NEW PUBLIC HOUSING PROJECTS AND TO USE A PORTION OF THE BALANCE FOR THE MODERNIZATION OF EXISTING PROJECTS. THIS WILL PROVIDE HOUSING AUTHORITIES WITH INCREASED FLEXIBILITY IN DEALING WITH LOCAL NEEDS.

IN CONJUNCTION WITH THE COMPREHENSIVE IMPROVEMENT ASSISTANCE PROGRAM, PHAS WILL BE EVALUATING THEIR PROJECTS TO DETERMINE

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WHETHER THEY CAN BE MADE AVAILABLE FOR LOW-INCOME TENANTS ON A COST-EFFECTIVE BASIS, OR WHETHER IT WOULD BE MORE EFFICIENT TO SELL OR DEMOLISH THEM AND PROVIDE THE TENANTS WITH MODIFIED SECTION 8 CERTIFICATES TO SECURE OTHER UNITS. THE REQUEST FOR AUTHORIZATION TO SELL OR DEMOLISH PUBLIC HOUSING UNITS MUST ORIGINATE WITH THE PHAS.

PUBLIC HOUSING OPERATING SUBSIDIES. FOR FY 1983 WE PROPOSE $1,075 MILLION TO FUND PUBLIC HOUSING OPERATING SUBSIDY REQUIREMENTS. THIS ESTIMATE REFLECTS ADJUSTMENTS IN OPERATING SUBSIDIES BASED ON PROPOSED PROCEDURAL AND REGULATORY CHANGES AFFECTING TENANT RENT PAYMENTS AND PHA OPERATION, MORE EFFICIENT PHA MANAGEMENT, INCREASED SUPPORT BY STATE AND LOCAL GOVERNMENTS, AND ANTICIPATED SAVINGS FROM IMPROVEMENTS IN ENERGY EFFICIENCY.

INCLUDED IN THE ADJUSTMENTS IS THE IMPACT OF INCREASING THE MAXIMUM ALLOWABLE RENT CONTRIBUTION TO 27 PERCENT OF INCOME IN 1983 FOR EXISTING PUBLIC HOUSING TENANTS AND 30 PERCENT OF INCOME FOR NEW PUBLIC HOUSING TENANTS.

DURING THE PAST SEVERAL MONTHS THE DEPARTMENT HAS BEEN EXAMINING ALTERNATIVE METHODS OF DISTRIBUTING OPERATING SUBSIDY

FUNDS, AS DIRECTED BY THE CONGRESS IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1981. WE HAVE NEARLY COMPLETED THE REPORT AND EXPECT TO BE ABLE TO SUBMIT IT TO THE COMMITTEE IN THE NEAR FUTURE.

ADJUSTMENTS IN TENANT RENT CONTRIBUTIONS. THE DEPARTMENT'S FY 1983 PROGRAM ANTICIPATES CONTINUATION OF THE PHASE-IN OF RENT INCREASES FOR SUBSIDIZED HOUSING TENANTS. THIS WILL BE COUPLED WITH AN ADMINISTRATION INITIATIVE TO TAKE FOOD STAMPS INTO ACCOUNT IN DETERMINING TENANT INCOME.

WE ALSO PROPOSE THAT THE DISCRETION GIVEN THE SECRETARY TO IMPLEMENT LAST YEAR'S RENT INCREASES BE AVAILABLE TO ASSURE THE GRADUAL PHASE-IN OF ANY INCREASES IN TENANT CONTRIBUTION RESULTING FROM IMPLEMENTATION OF THE MODIFIED CERTIFICATE PROGRAM.

IN ADDITION, WE ARE PROPOSING AN OVERALL 20% CAP ON ANNUAL RENT INCREASES ATTRIBUTABLE TO CERTAIN LEGISLATIVE CHANGES. SPECIFICALLY, THE CAP WOULD APPLY TO INCREASES ATTRIBUTABLE TO THE 1981 RENT INCREASE AMENDMENTS, TO THE DETERMINATION OF A FAMILY'S CONTRIBUTION UNDER THE MODIFIED CERTIFICATE PROGRAM, AND TO ANY CHANGE IN FEDERAL LAW DEALING WITH WHAT BENEFITS CAN BE COUNTED AS INCOME FOR HOUSING ASSISTANCE PURPOSES, E.G., FOOD STAMPS.

It should be noted that the rent burden for tenants who receive Federal assistance will continue to be significantly lower than for low-income families who do not receive such assistance. Very low-income renters not assisted by HUD programs are currently paying an average of 50 percent of their income for housing. Even under the proposed amendments, HUD-assisted tenants will, in general, be much better off than unassisted households.

Indian Housing. We plan to move the approximately 14,000 units now in the Indian housing pipeline to construction and occupancy. We expect these units to be completed at a rate of about 4,000 units per year over the next three years.

High development costs, excessive Federal requirements, and current management problems make it imperative to develop a more effective, less costly approach before additional new funds are made available. For this reason, the Department is not requesting new authority for Indian Housing in Fiscal Year 1983.

The Office of Management and Budget established a Task Force in the fall of 1981, to review Indian housing and related programs. HUD is a member of this Task Force which is now in the process of completing its report.

In the interim, we are emphasizing improvement in management practices by Indian Housing Authorities. Financially troubled Indian Housing Authorities have been asked to develop and implement Management Improvement Plans, and HUD Indian Field Office staff continue to be available to assist Indian communities in formulating appropriate actions to overcome financial and management problems.

New Directions for FHA

Our legislative proposals for FHA are directed to three primary objectives. We propose, first, to direct FHA's single-family programs to homebuyers unserved or underserved by the private sector; second, to modernize FHA programs to meet the changing requirements of the marketplace; and third, to increase housing affordability and achieve cost savings at HUD.

Negotiated Interest Rates. A change, long overdue, is the elimination of regulated mortgage interest rates for FHA programs. Under our proposal for negotiated rates, the mortgage interest rate, the commitment fee, and any discount points will be negotiated and agreed upon between the borrower and the lender. This change will allow interest rates to "float" with

THE MARKET, AND WILL IN MOST INSTANCES OBVIATE THE NEED FOR EXCESSIVE DISCOUNT POINTS.

ALTERNATIVE MORTGAGE INSTRUMENTS. WE ARE REQUESTING LIMITED AUTHORITY TO INSURE VARIOUS ALTERNATIVE MORTGAGE INSTRUMENTS TO KEEP PACE WITH A RAPIDLY CHANGING MORTGAGE MARKET.

BASED ON THE SUCCESS OF OUR GRADUATED PAYMENT MORTGAGE (GPM) PROGRAM FOR HOMEBUYERS, WE ARE PROPOSING A MORE LIMITED GPM AUTHORITY FOR USE WITH MULTIFAMILY RENTAL PROJECTS.

WE ARE ALSO PROPOSING TO OFFER ADJUSTABLE RATE MORTGAGES (ARMS). THIS WOULD ALLOW FHA HOMEBUYERS A CHOICE BETWEEN A FIXED-RATE MORTGAGE WITH AN INTEREST RATE CONTAINING AN INFLATION PREMIUM, OR AN ADJUSTABLE RATE MORTGAGE WHEREIN THE BORROWER SHARES WITH THE LENDER IN ANY INFLATION RISK.

THE DEPARTMENT'S PROPOSED SHARED APPRECIATION MORTGAGE (SAM) IS INTENDED FOR USE WITH BOTH SINGLE-FAMILY AND MULTI-FAMILY HOUSING. LIKE THE GPM CURRENTLY OFFERED BY FHA FOR SINGLE-FAMILY MORTGAGORS, THE SAM MAKES POSSIBLE MORE READILY AVAILABLE MORTGAGE CREDIT -- AND POSSIBLY LOWER INITIAL MONTHLY PAYMENTS --

IN EXCHANGE FOR A SHARING OF ANY APPRECIATION REALIZED AT LOAN TERMINATION OR SALE OF THE PROPERTY.

Mortgage Insurance Premiums. Our proposal to require the "upfront" payment of the FHA mortgage insurance premium (MIP) represents a substantial improvement in the Department's collection of premium payments--without burdening the mortgagor. The change will ensure that sufficient revenues are available to meet early year insurance claims. In addition, the change will lower the costs of administering the system for both FHA and participating lenders.

In order to relieve the mortgagor of the burden of having to make a larger cash downpayment at loan origination, we are proposing an amendment so that the "upfront" premium would not increase the mortgagor's downpayment. Under our proposal, the mortgagor would be able to amortize the lump-sum premium along with the full mortgage amount.

Other FHA Initiatives. We are also proposing other initiatives that will enable us to improve our efficiency and usefulness. These include a proposed amendment to Section 234(c) to eliminate the existing constraint on insuring units in non-FHA-insured condominium projects less than a year old, and

AMENDMENTS TO SECTIONS 207 AND 234(c)(2) TO REMOVE LANGUAGE REQUIRING HUD REGULATION OF INSURED PROJECT RENTS AND RATES OF RETURN, AND SUBSTITUTE DISCRETIONARY AUTHORITY IN THE SECRETARY. THE LATTER AMENDMENTS WILL PERMIT THE DEPARTMENT TO DEREGULATE RENT LEVELS IN ALL UNSUBSIDIZED, INSURED PROJECTS.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA)

MORTGAGE-BACKED SECURITIES PROGRAM. THROUGH THE MORTGAGED-BACKED SECURITIES PROGRAM, GNMA HAS PIONEERED THE DEVELOPMENT OF THE SECONDARY MARKET FOR MORTGAGE FINANCING. WE PROPOSE CONTINUATION OF THE MORTGAGE-BACKED SECURITIES PROGRAM AT A LEVEL OF $38.4 BILLION. THE LEVEL PROPOSED THIS YEAR REFLECTS A MORE REALISTIC ASSESSMENT OF THE AMOUNT OF CREDIT REQUIRED TO MEET PROGRAM DEMAND IN THE CURRENT ECONOMIC ENVIRONMENT. IT IS IMPORTANT TO NOTE THAT THE ACTUAL VOLUME OF SECURITIES ISSUED HAS NEVER COME CLOSE TO THE LEVELS NOW PROPOSED. IN ADDITION, WE ARE PUTTING IN PLACE IN FISCAL YEAR 1983 REASONABLE INCREASES IN COMMITMENT FEES THAT WILL RESTRAIN UNNECESSARY REQUESTS FOR COMMITMENTS.

WE BELIEVE THAT THE REDUCTION PROPOSED IN THE FY 1983 BUDGET WILL NOT HAVE A MAJOR IMPACT ON THE AMOUNT OF FINANCING AVAILABLE TO CONSUMERS FOR HOUSING. BY PUTTING A REALISTIC AND

PRACTICAL LIMIT ON GNMA, WE INTEND TO SEND TO THE MARKET A SIGNAL THAT THERE IS AMPLE ROOM FOR PRIVATE ALTERNATIVES TO GROW AND PROSPER, SUCH AS THE NEW MORTGAGE-BACKED SECURITIES PROGRAMS OF BOTH THE FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION. WE WILL CONTINUE TO SUPPORT THE MARKET BUT WE ARE LOOKING TO PRIVATE FIRMS TO PLAY AN INCREASINGLY IMPORTANT ROLE IN THE REST OF THIS DECADE.

TANDEM TERMINATION. WE ARE NOT PROPOSING ANY FURTHER FUNDING FOR THE GNMA TANDEM MORTGAGE PURCHASE PROGRAM. THIS PROGRAM HAS TURNED OUT TO BE MUCH MORE EXPENSIVE THAN ORIGINALLY CONTEMPLATED AND THE EFFECTS OFTEN HAVE NOT BEEN FOCUSED ON THE TRULY NEEDY. WE CAN NO LONGER AFFORD THE LUXURY OF DEVOTING SCARCE RESOURCES TO PUBLIC PROGRAMS THAT ARE EXPENSIVE YET OFTEN INADEQUATE.

FAIR HOUSING

THIS DEPARTMENT IS FIRMLY COMMITTED TO STRENGTHENING EXISTING FAIR HOUSING ENFORCEMENT PROCEDURES. THE DEPARTMENT HAS RETAINED STRONG CIVIL RIGHTS REQUIREMENTS TO ASSURE THAT ITS STATUTORY RESPONSIBILITIES CONTINUE TO BE MET. WE ARE ALSO STRENGTHENING THE SCOPE AND QUALITY OF OUR MONITORING AND

COMPLIANCE ACTIVITIES. CONNECTED WITH THIS EFFORT IS THE ESTABLISHMENT OF MECHANISMS FOR THE COLLECTION OF ACCURATE, TIMELY, AND ADEQUATE DATA TO ENFORCE OUR CIVIL RIGHTS OBLIGATIONS.

NEW COMMUNITY DEVELOPMENT CORPORATION

OUR GOAL HAS BEEN TO LIQUIDATE THE NEW COMMUNITIES PROGRAM AS QUICKLY AND AS EFFECTIVELY AS POSSIBLE. THE PROGRAM INITIALLY PROVIDED GUARANTEE SUPPORT FOR DEBT ISSUED FOR LAND ACQUISITION AND DEVELOPMENT FOR SOME 13 NEW COMMUNITIES. WHEN I TOOK OFFICE, LAST YEAR, 9 OF THOSE 13 HAD FAILED FINANCIALLY AND HAD BEEN ACQUIRED BY THE NEW COMMUNITY DEVELOPMENT CORPORATION (NCDC).

I AM PLEASED TO REPORT THAT THROUGH 1981 NCDC SOLD OR PARTIALLY DISPOSED OF FIVE OF THE FAILED COMMUNITIES RESULTING IN A RETURN TO HUD OF APPROXIMATELY $34 MILLION. THE REMAINING FOUR HUD-OWNED PROPERTIES ARE SCHEDULED TO BE SOLD WITHIN THE NEXT 12 MONTHS WITH AN EXPECTED RETURN TO HUD OF APPROXIMATELY $16 MILLION. WE ESTIMATE ADDITIONAL RECEIPTS TO HUD OF APPROXIMATELY $32 MILLION FROM SALVAGED PROPERTIES, FOR A CUMULATIVE TOTAL OF $82 MILLION.

CONCLUSION

THE PROGRAM CHANGES AND NEW DIRECTIONS BEING UNDERTAKEN BY THIS DEPARTMENT ARE IMPORTANT AND NECESSARY STEPS IN REORIENTING FEDERAL RESOURCES THAT NO LONGER CAN BE REGARDED AS UNLIMITED. WE BELIEVE THESE SCARCE RESOURCES SHOULD BE DIRECTED "TOWARD PEOPLE, NOT TOWARD STRUCTURES," IN THE WORDS OF THE PRESIDENT'S HOUSING COMMISSION.

FOR THE PAST YEAR, THIS ADMINISTRATION HAS WORKED DILIGENTLY TO DEVELOP A MORE RATIONAL AND ECONOMICALLY VIABLE APPROACH TO THE PROBLEM OF PROVIDING SHELTER FOR THE NATION'S POOR AND TO ATTACK THE SERIOUS LONG-TERM BUDGETARY PROBLEMS CREATED BY THE SECTION 8 PROGRAM. WE BELIEVE THESE PROPOSALS ARE COST-EFFECTIVE AND NEEDED, BUT, ABOVE ALL, ARE FAIR AND EQUITABLE. I URGE THIS COMMITTEE AND THE CONGRESS TO CONSIDER THEM CAREFULLY.

THE SECRETARY OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410
March 26, 1982

Honorable Thomas P. O'Neill, Jr.
Speaker of the House
of Representatives
Washington, D. C. 20515

Subject: Proposed "Housing and Community Development Amendments of 1982"

Dear Mr. Speaker:

I am enclosing proposed legislation to extend most HUD-FHA insuring authorities, to provide funding authorizations for certain programs of the Department, and to make a number of program amendments to existing authorities.

Among the major features of this proposal are:

-- A Modified Section 8 Existing Housing Assistance Program which will reduce housing subsidy costs, combat rent inflation, and provide greater mobility and housing choice for assisted families;

-- A Rental Rehabilitation Initiative designed to preserve the Nation's rental housing stock in low- and moderate-income neighborhoods and to complement the Modified Certificate proposal;

-- Elimination of the requirement that FHA interest rates be set by law, in favor of negotiated interest rates determined by mortgagor and mortgagee;

-- A series of authorizations designed to make FHA insurance more available to those unserved or underserved by the private sector, including provisions permitting the Department to insure single family and multifamily graduated payment mortgages and shared appreciation mortgages, and single family adjustable rate mortgages.

In addition to these initiatives, the proposal contains diverse program amendments designed to put the Department's housing assistance and mortgage insurance programs on a more businesslike footing, to simplify program administration, and to reduce Federal regulation.

A section-by-section explanation and justification accompanies this letter and more fully sets out the contents of the bill. Timely enactment of this proposal would provide the Department with the necessary authority to carry out its responsibilities effectively during fiscal year 1983. I request that the bill be referred to the appropriate committee and urge its early enactment.

The Office of Management and Budget has advised that the enactment of this legislation would be in accord with the program of the President.

Very sincerely yours,

Samuel R. Pierce, Jr.

Enclosure

(Identical letter sent to the President of the Senate)

I

97TH CONGRESS
2D SESSION

H. R. 6020

To amend and extend certain Federal laws relating to housing, community and neighborhood development, and related programs, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 31, 1982

Mr. STANTON of Ohio (by request) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To amend and extend certain Federal laws relating to housing, community and neighborhood development, and related programs, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Housing and Community Development Amendments of 1982".

TITLE I—COMMUNITY AND NEIGHBORHOOD DEVELOPMENT

RENTAL REHABILITATION

SEC. 101. (a) Title I of the Housing and Community Development Act of 1974 is amended by adding the following new section at the end thereof:

"RENTAL REHABILITATION

"SEC. 122. (a) The Secretary is authorized to—

"(1) make rental rehabilitation grants to States and units of general local government to help support the rehabilitation of privately owned real property to be used for primarily residential rental purposes; and

"(2) make available contract authority as provided by section 8(b)(3)(B) of the United States Housing Act of 1937 ("modified certificates"), to minimize the displacement of very low-income tenants of structures rehabilitated with assistance under this section, to assist very low-income tenants of these structures who are displaced by such rehabilitation activities, and to assist other very low-income tenants in obtaining decent, safe, and sanitary housing.

Of the total amount approved in appropriation Acts under section 103 for fiscal year 1983, not more than $150,000,000 shall be available for that year for rental rehabilitation grants under this section.

"(b)(1) Of the amount available in any fiscal year for grants under subsection (a)(1), the Secretary shall allocate amounts for cities which have a population of fifty thousand or more, urban counties, and States, taking into account such factors as low-income renter population, rental housing market conditions, overcrowding of rental housing, the condi-

tion of the rental housing stock, and such other objectively measurable conditions as the Secretary deems appropriate to further the purposes of this section.

"(2) Before an allocation determined under paragraph (1) for any fiscal year is made available for use, the Secretary may adjust the allocation as follows:

"(A) The Secretary is authorized to establish minimum allocation amounts for cities and urban counties, representing program levels below which, in the Secretary's determination, conduct of a rental rehabilitation program would not be feasible. The amount of any allocation which is below this minimum shall be added to the allocation for the State in which the city or county is located.

"(B) Beginning with fiscal years after fiscal year 1983, the Secretary is authorized to adjust the allocation for a city, urban county, or State administering a rental rehabilitation program as provided in subsection (e)(1), by up to 15 per centum above or below the amount of such allocation, based on an annual review of each such entity's performance in carrying out activities under this section. The Secretary shall establish performance criteria for purposes of this subparagraph, which shall include performance in achieving the result that at least 80 per centum of the initial rents, on a

free-market basis, for units rehabilitated with assistance under this section are within the applicable payment standard for the area, as determined under section 8(d)(1) of the United States Housing Act of 1937. Subparagraph (A) shall not apply to an allocation which falls below the minimum amount described therein by reason of an adjustment under this subparagraph.

"(3)(A) The Secretary shall allocate the contract authority for modified certificates referred to in subsection (a)(2) for use in each city referred to in paragraph (1) of this subsection, urban county, and State in the same proportion as each such entity's allocation of rental rehabilitation grants under paragraphs (1) and (2) of this subsection bears to the total amount of such grants available for allocation to all such entities for that fiscal year.

"(B) The annual contributions contract covering the contract authority referred to in the preceding subparagraph shall contain such terms and conditions as the Secretary deems appropriate to carry out the purposes of this section, including provisions to assure that the appropriate public housing agency makes such authority available to eligible tenants of structures rehabilitated with assistance under this section.

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"(4) The Secretary shall, at least on an annual basis, make such reviews and audits as may be necessary or appropriate to determine—

"(A) where the grantee is a unit of general local government or a State carrying out its own rental rehabilitation program as provided in subsection (e)(1)(A), whether (i) the grantee has carried out its activities in a timely manner and in accordance with the requirements of this section and of section 107(d), and has a continuing capacity to carry out those activities in a timely manner, and (ii) the modified certificates made available under this section have been administered in accordance with the requirements of the United States Housing Act of 1937 and of this section; and

"(B) where the grantee is a State distributing resources made available under this section to units of general local government as provided in subsection (e)(1)(B), whether the State (i) has distributed such resources in a timely manner and in accordance with the requirements of this section and of section 107(d) and (ii) has made such reviews and audits of the units of general local government as may be necessary or appropriate to determine whether they have satisfied the performance criteria described in subparagraph (A)(i) of this paragraph.

The Secretary may adjust, reduce, or withdraw resources made available to States and units of general local government receiving assistance under this section, or take other action as appropriate in accordance with the findings of these reviews and audits, except that resources already expended on eligible activities shall not be recaptured or deducted from future resources made available to the grantee. Any amounts which become available as a result of actions under this paragraph or section 111 shall be reallocated in the year in which they become available to such grantee or grantees as the Secretary may determine.

"(5) The Secretary is authorized to establish maximum levels of rental rehabilitation grant amounts which a grantee may receive under this subsection in any fiscal year. These maxima may be expressed as percentage increments above the allocations determined under paragraphs (1) and (2) of this subsection.

"(6) Any rental rehabilitation grant amounts which are not obligated at the end of any fiscal year shall be added to the amount available for allocation for such grants for the succeeding fiscal year.

"(c) Any city or urban county receiving an allocation under subsection (b) and any State administering a rental rehabilitation program as provided in subsection (e)(1) shall prepare an annual statement containing a description of its

rental rehabilitation program. Except in the case of a State distributing resources as provided in subsection (e)(1)(B), the statement shall consist of the activities each entity proposes to undertake for the fiscal year, including its projected progress in carrying out those activities. The statement of a State distributing resources as provided in subsection (e)(1)(B) shall consist of its proposed method of distributing the resources. No later than December 31 of the year in which the program is to be undertaken, the statement shall be made available to the public, and a copy shall be furnished to the Secretary.

"(d) Rental rehabilitation programs assisted under this section shall meet the following requirements:

"(1) rental rehabilitation grants shall only be used to rehabilitate structures which are (A) located in low- and moderate-income areas, as defined and designated by the grantee, and (B) to be used for primarily residential rental purposes;

"(2) dwelling units in structures rehabilitated with assistance under this section shall meet the housing quality standards established by the Secretary for the modified certificate program under section 8 of the United States Housing Act of 1937;

"(3) rental rehabilitation assistance provided under this section for any structure shall not exceed 50 per centum of the total rehabilitation costs associated with

the rehabilitation of that structure, as determined by the Secretary;

"(4) States and units of general local government receiving assistance under this section shall not impose rental requirements on structures rehabilitated with assistance under this section (including requirements relating to the rents which may be charged after rehabilitation) which differ from those applicable to structures undergoing comparable rehabilitation without assistance under this section;

"(5) an owner of a structure rehabilitated with assistance under this section shall not refuse to rent a dwelling unit in the structure to a family solely because the family is receiving rental assistance under section 8 of the United States Housing Act of 1937;

"(6) rehabilitation financing for a structure assisted under this section shall, to the maximum extent practicable, require that the borrower shall be personally liable for repayment of all such financing in the event of default; and

"(7) States and units of general local government receiving rental rehabilitation assistance under this section shall not deduct therefrom any amounts to cover administrative expenses incurred by them in carrying out their responsibilities under this section.

"(e)(1) Except as provided in paragraph (2), the State shall administer resources made available under subsection (b) for any fiscal year. These resources shall only be used to carry out activities under this section in areas of the State outside a city or urban county which received an allocation for that fiscal year under subsection (b). The State may use all or part of these resources (A) to carry out its own rental rehabilitation program or (B) to distribute them to units of general local government.

"(2) States may elect not to administer resources made available for fiscal year 1983. This election shall be made in such manner and before such time as the Secretary may prescribe. The Secretary shall administer the resources available to any State exercising such an election in accordance with regulations and procedures prescribed by the Secretary, which regulations shall, to the maximum extent practicable, be comparable to those for cities and urban counties receiving resources under subsection (b).

"(f) The Secretary may by regulation establish such standards governing relocation payments and other related assistance as the Secretary determines to be appropriate.

"(g)(1) The Secretary shall establish procedures which support national historic preservation objectives and which assure that, if any rehabilitation proposed to be assisted under this section would affect property that is included on

the National Register of Historic Places, such activity shall not be undertaken unless (A) it will reasonably meet the standards for rehabilitation issued by the Secretary of the Interior and the appropriate State historic preservation officer is afforded the opportunity to comment on the specific rehabilitation plan, or (B) the Advisory Council on Historic Preservation is afforded an opportunity to comment on cases for which the recipient of assistance, in consultation with the State historic preservation officer, determines that the proposed rehabilitation activity cannot reasonably meet such standards or would adversely affect historic property as defined therein.

"(2) The Secretary's award and recipient use of resources made available under this section shall not be subject to the National Environmental Policy Act and the provisions of related laws and authorities as identified by the Secretary's regulations issued pursuant to section 104(f) of this Act.

"(h) For purposes of this section, the term 'grantee' means (1) any city or urban county receiving resources under subsection (b), (2) any State administering a rental rehabilitation program as provided in subsection (e)(1), and (3) any unit of general local government which receives assistance from the Secretary as provided in subsection (e)(2).".

(b) The first sentence of section 104(g)(1) of such Act is amended by inserting "(except funds under section 122(a)(1))" after "funds".

(c) The first sentence of each of section 106 (a) and (d)(1) of such Act is amended by striking out "and section 119" and inserting in lieu thereof ", section 119, and section 122".

(d) Section 107(d) of such Act is amended by—

(1) striking out "unless the applicant" in paragraph (1) and inserting in lieu thereof the following: "and no assistance may be made available under section 122 unless the grantee"; and

(2) inserting "grantee or" before "applicant" in paragraph (3).

URBAN HOMESTEADING

SEC. 102. (a) The first sentence of section 810(h) of the Housing and Community Development Act of 1974 is amended by striking out "and not to exceed $13,467,000 for the fiscal year 1983" and inserting in lieu thereof "not to exceed $12,000,000 for the fiscal year 1983, and such sums as may be necessary for the fiscal year 1984".

(b) Section 810 of such Act is amended—

(1) striking out "without payment" in the first sentence of subsection (a) and inserting immediately before "any real property" in such sentence the follow-

ing: "for such consideration (if any) as may be mutually agreed upon,";

(2) striking out "without payment" in clause (D) in the second sentence of subsection (a) and inserting in lieu thereof the following: ", offset by any consideration to be received";

(3) striking out "without any substantial consideration" in subsection (b)(1) and inserting in lieu thereof the following: "for such consideration, if any, as may be agreed upon by the entity and the individual or family";

(4) striking out "and" the first time it appears in subsection (b)(2) and inserting in lieu thereof a comma;

(5) inserting immediately before the semicolon at the end of subsection (b)(2) the following: ", and ability to pay any consideration required in connection with conveyance of the property";

(6) striking out "and" at the end of subsection (b)(3)(C) and inserting "and" after the semicolon at the end of subsection (b)(3)(D);

(7) adding the following new subparagraph at the end of subsection (b)(3):

"(E) pay the agreed-upon consideration for the property;";

(8) striking out "without consideration" in subsection (b)(5); and

(9) adding the following new material at the end of subsection (b):

"Any unit of general local government, State, or agency designated by either, which receives consideration in connection with the conveyance of a property to an individual or family under this section in an amount exceeding any consideration paid to the Secretary in connection with the transfer of the property to any such entity, shall remit to the Secretary, in such manner and at such time or times as the Secretary may prescribe, 50 per centum of the amount of such excess, less such deductions and allowances as the Secretary may prescribe. Any amount retained by an entity pursuant to the preceding sentence shall be used by the entity in furtherance of its urban homesteading activities.".

(c) Section 810 of such Act is amended by—

(1) adding "or (i)" immediately after "subsection (b)" in subsection (c); and

(2) adding the following new subsection at the end thereof:

"(i) Notwithstanding any other provision of law, including any other provision of this section, the Secretary is authorized to undertake a program to demonstrate the feasibility and desirability of using a variety of homesteading and

related techniques to facilitate the reuse for homeownership purposes of properties which are owned by the Secretary and contain five or more dwelling units. The Secretary shall convey properties which the Secretary determines are suitable for the demonstration to a unit of general local government or a State, or an agency or instrumentality of a unit of general local government or a State, for such consideration (if any) as may be agreed between the Secretary and the transferee, and upon such terms and conditions as the Secretary deems appropriate, including provisions to assure that the subsequent transfer of the property to private ownership will result in a reuse which is primarily residential, with dwelling units in the project owned by individuals under a cooperative or condominium form of ownership. In carrying out this demonstration, the Secretary shall, to the maximum extent feasible, minimize the displacement of residents of properties to be used in the program. To reimburse the housing loan funds for properties transferred under this subsection, the Secretary is authorized, to the extent provided in appropriation Acts, to use amounts appropriated under subsection (h).".

REPEALERS

SEC. 103. (a)(1) Section 312 of the Housing Act of 1964 is hereby repealed, except that the first and second sentences of subsection (d) of such section shall remain in effect until September 30, 1983, or until such earlier time as

the assets and liabilities of the revolving fund under such section are transferred to the revolving fund for liquidating programs established pursuant to title II of the Independent Office Appropriation Act of 1955. All moneys in the revolving fund for liquidating programs shall be available for necessary expenses of servicing and liquidating loans made pursuant to section 312, including reimbursement or payment for services and facilities of the Government National Mortgage Association and of any public or private entity for the servicing or liquidation of such loans.

(2) Any loan which, before the effective date of this subsection, was obligated under and governed by section 312 of such Act shall continue to be governed by the provisions of such section 312 as they existed immediately before such effective date.

(b)(1) Section 414 of the Housing and Urban Development Act of 1969 is hereby repealed.

(2) Notwithstanding paragraph (1) of this subsection, the Secretary of Housing and Urban Development and the Secretary of Agriculture may dispose of Federal surplus real property pursuant to the terms of section 414 of such Act if, prior to the effective date of this Act, either Secretary had requested the Administrator of General Services to transfer such property for such disposition: *Provided*, That, if either Secretary has not so disposed of any such property within

one hundred and twenty days of the effective date of this Act, such property shall be transferred back to the Administrator.

(3) Notwithstanding paragraph (1) of this subsection, subsection (b) of section 414 of such Act shall continue to apply, where applicable, to all property transferred by either Secretary pursuant to section 414 of such Act, including properties transferred pursuant to paragraph (2) of this subsection.

(c)(1) Section 106(g) of the Housing Act of 1949 is hereby repealed.

(2) Section 703(d) of the Housing and Urban Development Act of 1965 is hereby repealed.

(3) Sections 704 and 705 and the second sentence of section 706 of the Housing Act of 1961 are hereby repealed.

TITLE II—HOUSING ASSISTANCE PROGRAMS

ALLOCATION AND USE OF ASSISTED HOUSING AUTHORITY

SEC. 201. (a) Section 213(d) of the Housing and Community Development Act of 1974 is hereby repealed.

(b) Section 5(c) of the United States Housing Act of 1937 is amended by—

(1) striking out the last sentence of paragraph (1); and

(2) striking out paragraphs (2) and (3) and redesignating the remaining paragraphs accordingly.

MODIFIED SECTION 8 EXISTING HOUSING ASSISTANCE PROGRAM

SEC. 202. (a) Section 8(b) of the United States Housing Act of 1937 is amended by adding the following new paragraph at the end thereof:

"(3) Assistance contracts entered into under this section shall provide for either (A) assistance payments under subsection (c) of this section based upon the maximum monthly rent which the owner is entitled to receive for each dwelling unit with respect to which the payments are to be made, or (B) assistance payments under subsection (d) of this section based upon a payment standard which is used to determine the maximum monthly assistance which may be paid for any family. Assistance contracts using a payment standard shall only be entered into pursuant to annual contributions contracts which are executed after the effective date of the Housing and Community Development Amendments of 1982, and which provide for modified certificate assistance with respect to existing dwelling units selected by the family to be assisted.".

(b) Section 8(c) of such Act is amended by—

(1) striking out the designation "(c)(1)" and the first sentence of paragraph (1) and inserting in lieu thereof the following:

"(c) In the case of assistance contracts using a maximum monthly rent:

"(1) The contract shall establish the maximum monthly rent (including utilities and all maintenance and management charges) which the owner is entitled to receive for each dwelling unit with respect to which such assistance payments are to be made.";

(2) striking out the penultimate sentence in paragraph (1) and inserting in lieu thereof the following: "Fair market rentals for an area shall be published in the Federal Register.";

(3) striking out the second sentence in paragraph (3);

(4) striking out "under this section" in paragraph (8) and inserting in lieu thereof "for newly constructed or substantially rehabilitated units"; and

(5) adding the following new paragraphs at the end thereof:

"(9) Contracts to make assistance payments entered into by a public housing agency with an owner of existing housing units shall be for a term of not less than one month nor more than one hundred and eighty months and shall provide (with respect to any unit) that—

"(A) the selection of tenants for such units shall be the function of the owner, subject to the provisions

of the annual contributions contract between the Secretary and the agency, except that the tenant selection criteria shall give preference to families which, at the time they are seeking assistance, occupy substandard housing or are involuntarily displaced;

"(B) the lease between the tenant and the owner shall be for at least one year or the term of such contract, whichever is shorter, and shall contain other terms and conditions specified by the Secretary;

"(C) the owner shall not terminate the tenancy except for serious or repeated violation of the terms and conditions of the lease, for violation of applicable Federal, State, or local law, or for other good cause;

"(D) maintenance and replacement (including redecoration) shall be in accordance with the standard practice for the building concerned as established by the owner and agreed to by the agency; and

"(E) the agency and the owner shall carry out such other appropriate terms and conditions as may be mutually agreed to by them.

"(10) Notwithstanding any other provision of law, with the approval of the Secretary the public housing agency administering an assistance contract with respect to existing housing units may exercise all management and maintenance

responsibilities with respect to those units pursuant to a contract between such agency and the owner of such units.".

(c) Section 8(d) of such Act is amended to read as follows:

"(d) In the case of assistance contracts using a payment standard:

"(1) The Secretary shall establish payment standards for dwelling units of various sizes and types in the market area. The payment standard shall be used to determine the maximum monthly assistance which may be paid for any family, as provided in paragraph (2) of this subsection. Payment standards shall be established at levels designed to assist families in securing decent, safe and sanitary housing while providing assistance to the greatest possible number of families. Payment standards for an area shall be published in the Federal Register.

"(2) The monthly assistance payment for any family shall be the amount by which the payment standard for the area exceeds 30 per centum of the family's monthly adjusted income; except that such monthly assistance payment shall not exceed the amount by which the rent for the dwelling unit (including the amount allowed for utilities in the case of a unit with separate utility metering) exceeds the greater

of (A) 10 per centum of the family's monthly income or (B), if the family is receiving payments for welfare assistance from a public agency and a part of such payments, adjusted in accordance with the family's actual housing costs, is specifically designated by such agency to meet the family's housing costs, the portion of such payments which is so designated. In no event shall any monthly assistance payment for a family exceed the amount by which the payment standard exceeds 30 per centum of the family's monthly adjusted income at the time the family first receives assistance under this subsection.

"(3) Assistance payments may be made only for (A) a family determined to be a very low-income family at the time it initially receives assistance or (B) a family previously assisted under this Act. In selecting families to be assisted, preference shall be given to those which, at the time they are seeking assistance, occupy substandard housing, are involuntarily displaced, or are paying more than 50 per centum of family income for rent.

"(4) The Secretary is authorized, without regard to the preference contained in the preceding paragraph, to use all or any of the authority to enter into contracts under section 5(c) to make assistance payments

under this subsection for families (A) previously assisted under this Act, (B) eligible for assistance under the second sentence of section 203 of the Housing and Community Development Amendments of 1978, or (C) residing in dwellings to be rehabilitated with assistance under section 122 of the Housing and Community Development Act of 1974.

"(5) If a family vacates a dwelling unit before the expiration of a lease term, no assistance payment may be made with respect to the unit after the month during which the unit was vacated.

"(6) Contracts to make assistance payments for a dwelling unit shall be for a term of not less than one month nor more than sixty months. The Secretary shall require (with respect to any unit) that (A) the public housing agency inspect the unit before any assistance payment may be made to determine that it meets housing quality standards established by the Secretary, and (B) the public housing agency make annual or more frequent inspections during the contract term. No assistance payment may be made for a dwelling unit which fails to meet such quality standards, unless any such failure is promptly corrected by the owner and the correction verified by the public housing agency.".

(d) Section 8(j) of such Act is amended by redesignating paragraph (8) as paragraph (9) and inserting a new paragraph (8), to read as follows:

"(8) Assistance contracts entered into under this subsection pursuant to annual contributions contracts executed from the effective date of the Housing and Community Development Amendments of 1982 with respect to any family which rents real property on which is located a manufactured home which is owned by such family or any family which rents an existing manufactured home and the real property on which it is located shall provide for assistance payments based upon a payment standard as referred to in subsection (b)(3)(B). Paragraphs (2) through (7) of this subsection shall not apply to assistance contracts referred to in the previous sentence. The provisions of subsection (d) shall govern payments for families renting manufactured home spaces or manufactured homes and spaces under contracts based upon a payment standard, except that (A) the Secretary shall have discretion to modify the amount of the standard as appropriate for application to the rental of manufactured home spaces and manufactured homes and spaces, (B) the term 'rent' in subsection (d)(2) shall include the monthly payment to amortize the cost of purchasing the manufactured home, where the assisted family owns the home, and (C) with respect to any family renting real property on which is located a manufactured

home which is owned by the family, the monthly assistance payment under subsection (d)(2) shall in no event exceed the actual cost of renting such real property.".

AMENDMENTS AFFECTING TENANT RENTS OR CONTRIBUTIONS

SEC. 203. (a) Section 3(a) of the United States Housing Act of 1937 is amended by—

(1) adding the following immediately after the first sentence: "Reviews of family income shall be made at least annually."; and

(2) inserting after "under this Act" in the final sentence the following: "(other than a family assisted under section 8(d))".

(b) Section 3(b) of such Act is amended by striking out the period at the end of paragraph (2) and inserting in lieu thereof the following: ", except that the Secretary may establish income ceilings higher or lower than 50 per centum of the median for the area on the basis of the Secretary's findings that such variations are necessary because of unusually high or low family incomes.".

(c) Section 322(i)(1) of the Omnibus Budget Reconciliation Act of 1981 is amended to read as follows:

"(i)(1)(A) The provisions of this subparagraph (A) apply to determinations of the rent to be paid by or the contribution required of a tenant occupying housing assisted under the

authorities amended by this section ("assisted housing") on or before the effective date of regulations implementing section 202 of the Housing and Community Development Amendments of 1982:

"(i) Notwithstanding the provisions of subsections (a) through (h) of this section or section 202 of the Housing and Community Development Amendments of 1982, the Secretary may provide for delayed applicability, or for staged implementation, of the procedures for determining rents or contributions, as appropriate, required by such provisions if the Secretary determines that immediate application of such procedures would be impracticable, would violate the terms of existing leases, or would result in extraordinary hardship for any class of tenants. Application of the procedures for determining rent contained in subsections (a) through (h) of this section shall not result in a reduction in the amount of rent paid by any tenant below the amount paid by such tenant immediately preceding the effective date of this Act.

"(ii) The Secretary shall provide that the rent or contribution, as appropriate, required to be paid by a tenant shall not increase as a result of the amendments made by this section and by section 202 of the Housing and Community Development Amendments of

1982, and as a result of any other provision of Federal law redefining which governmental benefits are required to or may be considered as income, by more than 20 per centum during any twelve-month period, unless the increase above 20 per centum is attributable to causes unrelated to such amendments or redefinitions.

"(B) Tenants of assisted housing other than those referred to in subparagraph (A) shall be subject to immediate rent payment or contribution determinations in accordance with applicable law and without regard to the provisions of subparagraph (A), but the Secretary shall provide that the rent or contribution payable by any such tenant who is occupying assisted housing on the effective date of any provision of Federal law redefining which governmental benefits are required to or may be considered as income shall not increase, as a result of any such provision of Federal law, by more than 20 per centum during any twelve-month period, unless the increase above 20 per centum is attributable to causes unrelated to such redefinitions.

"(C) The limitations on increases in rent contained in subparagraphs (A)(ii) and (B) shall remain in effect and may not be changed or superseded except by another provision of law which amends this subsection.

"(D) As used in this paragraph, the term 'contribution' means an amount representing 30 per centum of a tenant's monthly adjusted income, 10 per centum of the tenant's monthly income, or the welfare assistance amount designated by a public agency to meet housing costs, whichever amount is used to determine the monthly assistance payment for the tenant under section 8(d)(2) of the United States Housing Act of 1937. Notwithstanding the last sentence of such section 8(d)(2), when the contribution otherwise required by section 8(d)(2) is reduced for a tenant in accordance with the provisions of this paragraph, the Secretary shall increase the monthly assistance payment for that tenant by an amount equal to that reduction.".

(f) Section 322(i) of the Omnibus Budget Reconciliation Act of 1981 is further amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

INCREASED AUTHORITY FOR PAYMENTS FOR OPERATION OF LOWER INCOME HOUSING PROJECTS

SEC. 204. Section 9(c) of the United States Housing Act of 1937 is amended by—

(1) striking out "and" after "October 1, 1980,"; and

(2) inserting before the period at the end thereof the following: ", not to exceed $1,075,000,000 on or

after October 1, 1982, and such sums as may be necessary on or after October 1, 1983".

DEMOLITION OF OBSOLETE PUBLIC HOUSING

SEC. 205. (a) Section 14(f) of the United States Housing Act of 1937 is amended to read as follows:

"(f) Where an application for financial assistance pursuant to this section proposes use of assistance for the demolition of any public housing project or any portion of such a project, the Secretary may approve the application if the Secretary determines that—

"(1) the project or the portion of the project is obsolete as to physical condition, or location, or other factors, making it unusable for housing purposes, and no program of modifications is feasible or such a program would not return the project or the portion of the project to useful life; or

"(2) in the case of an application proposing demolition of a portion of a project, the demolition will help to assure the useful life of the project; and

"(3) families displaced as a result of the demolition will be given an opportunity to relocate to other decent, safe, sanitary and affordable housing.

The Secretary may approve assistance in accordance with paragraph (1) without regard to the provisions of subsections (d), (e), (g) and (h).".

(b) The first sentence of section 14(d) of such Act is amended by striking out "subsection (e)(4)" and inserting in lieu thereof "subsections (e)(4) and (f)".

PURCHASE OF PHA OBLIGATIONS

SEC. 206. Section 329E of the Omnibus Budget Reconciliation Act of 1981 is hereby repealed.

OPERATING ASSISTANCE FOR TROUBLED MULTIFAMILY HOUSING PROJECTS

SEC. 207. (a) Section 201 of the Housing and Community Development Amendments of 1978 is amended by—

(1) striking out paragraph (1)(A) of subsection (c) and inserting in lieu thereof the following:

"(1)(A)(i) is covered by a mortgage insured or formerly insured under the National Housing Act and is assisted under section 236 of the National Housing Act or under section 101 of the Housing and Urban Development Act of 1965 or (ii) is assisted under the proviso of section 221(d)(5) of the National Housing Act; or"; and

(2) striking out ", together with the mortgagee in the case of a project not insured under the National Housing Act," in subsection (d)(3).

(b) Section 236(f)(3) of the National Housing Act is amended by striking out "September 30, 1982" and inserting in lieu thereof "September 30, 1984".

HOUSING FOR THE ELDERLY AND HANDICAPPED

SEC. 208. Section 202(d)(B) of the Housing Act of 1959 is amended by striking out "(i)" and all that follows through "(ii)".

TITLE III—PROGRAM AMENDMENTS AND EXTENSIONS

EXTENSION OF FEDERAL HOUSING ADMINISTRATION MORTGAGE INSURANCE PROGRAMS

SEC. 301. (a) Section 2(a) of the National Housing Act is amended by striking out "October 1, 1982" in the first sentence and inserting in lieu thereof "October 1, 1984".

(b) Section 217 of such Act is amended by—

(1) striking out "September 30, 1982" and inserting in lieu thereof "September 30, 1984";

(2) inserting "section 232," after "section 221,"; and

(3) inserting "section 242," after "section 236,".

(c) Section 221(f) of such Act is amended by striking out "September 30, 1982" in the fifth sentence and inserting in lieu thereof "September 30, 1984".

(d) Section 232 of such Act is amended by adding a new subsection at the end thereof as follows:

"(j) No mortgage may be insured under this section after September 30, 1982, except pursuant to a commitment to insure made before that date.".

(e) Section 235(m) of such Act is amended by striking out "September 30, 1982, except pursuant to a commitment to insure before that date" and inserting in lieu thereof "September 30, 1983".

(f) Section 242 of such Act is amended by adding a new subsection at the end thereof as follows:

"(i) No mortgage may be insured under this section after September 30, 1982, except pursuant to a commitment to insure made before that date.".

(g) Section 244(d) of such Act is amended by striking out "September 30, 1982" and inserting in lieu thereof "September 30, 1984".

(h) Section 1002(a) of such Act is amended by striking out "September 30, 1982" in the second sentence and inserting in lieu thereof "September 30, 1984".

FEDERAL HOUSING ADMINISTRATION GENERAL INSURANCE FUND

SEC. 302. Section 519(f) of the National Housing Act is amended by—

(1) inserting "such sums as may be necessary" immediately after "appropriated"; and

(2) striking out all that follows "Fund" and inserting in lieu thereof a period.

RESEARCH AUTHORIZATIONS

SEC. 303. The second sentence of section 501 of the Housing and Urban Development Act of 1970 is amended by striking out "and not to exceed $35,000,000 for the fiscal year 1982" and inserting in lieu thereof "not to exceed $35,000,000 for the fiscal year 1982, not to exceed $20,000,000 for the fiscal year 1983, and such sums as may be necessary for the fiscal year 1984".

ELIMINATION OF REQUIREMENTS THAT FHA INTEREST RATES BE SET BY LAW

SEC. 304. (a) Sections 3 and 4 of Public Law 90–301 are hereby repealed.

(b) The National Housing Act is amended in the following respects:

(1) Section 2(b)(5) is amended to read as follows:

"(5) No insurance shall be granted under this section to any such financial institution with respect to any obligation representing any such loan, advance of credit, or purchase by it unless the obligation has such maturity, bears such insurance premium charges, and contains such other terms, conditions, and restrictions as the Secretary shall prescribe, in order to make credit available for the purpose of this title. Any such obligation with respect to which insurance is granted under this section shall bear interest at such rate as

may be agreed upon by the borrower and the financial institution.".

(2) Section 203(b)(5) is amended to read as follows:

"(5) Bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee.".

(3) Section 203(k)(3)(B) is amended to read as follows:

"(B) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee;".

(4) The first sentence of the first undesignated paragraph of section 207(c)(3) is amended to read as follows: "The mortgage shall provide for complete amortization by periodic payments within such term as the Secretary shall prescribe, and shall bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee.".

(5) The first sentence of section 213(d) is amended to read as follows: "Any mortgage insured under this section shall provide for complete amortization by periodic payments within such term as the Secretary may prescribe but not to exceed forty years from the beginning of amortization of the mortgage, and shall bear in-

terest at such rate as may be agreed upon by the mortgagor and the mortgagee.”.

(6) The second sentence of section 220(d)(4) is amended to read as follows: “The mortgage shall bear interest at such rate as may be agreed upon by the mortgagor and mortgagee and contain such terms and provisions with respect to the application of the mortgagor's periodic payment to amortization of the principal of the mortgage, insurance, repairs, alternations, payment of taxes, default reserves, delinquency charges, foreclosure proceedings, anticipation of maturity, additional and secondary liens, and other matters as the Secretary may in the Secretary's discretion prescribe.”.

(7) Section 220(h)(2)(iii) is amended to read as follows:

“(iii) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee;”.

(8) Section 221(d)(5) is amended by striking out “(exclusive” and all that follows through “mortgage market” and inserting in lieu thereof the following: “at such rate as may be agreed upon by the mortgagor and the mortgagee”.

(9) Section 231(c)(6) is amended to read as follows:

"(6) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee; and".

(10) The first sentence of section 234(f) is amended to read as follows: "Any blanket mortgage insured under subsection (d) shall provide for complete amortization by periodic payments within such terms as the Secretary may prescribe but not to exceed forty years from the beginning of amortization of the mortgage, and shall bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee.".

(11) Section 235(i)(3) is amended by—

(A) striking out "and" at the end of subparagraph (D);

(B) striking out the period at the end of subparagraph (E) and inserting in lieu thereof "; and"; and

(C) adding the following new subparagraph at the end thereof:

"(F) bear interest at a rate not to exceed such per centum per annum on the amount of the principal obligation outstanding at any time as the Secretary finds necessary to meet the mortgage market, taking into consideration the yields on

mortgages in the primary and secondary markets.".

(12) Section 240(c)(4) is amended to read as follows:

"(4) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee;".

(13) Section 241(b)(3) is amended to read as follows:

"(3) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee;".

(14) Section [illegible](2) is amended to read as follows:

"(2) bear interest at such rate as may be agreed upon by the mortgagor and the mortgagee: *Provided*, That the Secretary may agree to a reasonable extension of the term of a mortgage, the maturity of which is limited by this paragraph to not more than ten years, if the Secretary determines that unusual or unforeseen circumstances make such extension necessary to avoid undue hardship to the mortgagor.".

[illegible]

[illegible]

SEC. 315. (a) Section [illegible] of the National Housing Act is amended by

(1) inserting after "150 per centum of such median price" in the first sentence of paragraph (2) the following: ": *Provided*, That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured"; and

(2) inserting after "cost of acquisition" in paragraph (9) the following: "(excluding the mortgage insurance premium paid at the time the mortgage is insured)".

(b) Section 213(b)(2) of such Act is amended by inserting after "exceeded by not to exceed 90 per centum in such an area" the following: ": *Provided further*, That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured".

(c) Section 221(d) of such Act is amended by—

(1) inserting after "in any geographical area where he finds that cost levels so require" in paragraph (2)(A) the following: ": *Provided further*, That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured";

(2) inserting after "of its acquisition cost" in paragraph (2)(B)(i)(2) the following: "(excluding the mort-

gage insurance premium paid at the time the mortgage is insured)"; and

(3) striking out "mortgage insurance premium," in paragraph (2)(B)(i)(2).

(d) Section 234(c) of such Act is amended by inserting after "one-family house price in the area, as determined by the Secretary" in clause (A) of the third sentence thereof the following: ": *Provided,* That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured".

(e) Section 235(i) of such Act is amended by—

(1) inserting after "respectively" in paragraph (3)(B) the following: ": *Provided,* That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured";

(2) inserting after "respectively" in paragraph (3)(C) the following: ": *Provided,* That the foregoing maximum mortgage amounts may be increased by the amount of the mortgage insurance premium paid at the time the mortgage is insured";

(3) inserting after "so require)" in paragraph (3)(D) the following: ": *Provided,* That the foregoing maximum mortgage amounts may be increased by the

amount of the mortgage insurance premium paid at the time the mortgage is insured"; and

(4) inserting after "acquisition" in paragraph (3)(E) the following: "(excluding the mortgage insurance premium paid at the time the mortgage is insured)".

NONOCCUPANT SINGLE-FAMILY MORTGAGORS

SEC. 306. Section 203(b)(8) of the National Housing Act is amended by striking out all that follows "an amount equal to" through "subsection:" and inserting in lieu thereof the following: "the lesser of (A) the otherwise applicable maximum dollar amount prescribed under paragraph (2) of this subsection or (B) 85 per centum of the otherwise applicable mortgage limitation based on the percentage of appraised value prescribed under such paragraph:".

PREMIUM CHARGES FOR INSURANCE OF ALTERNATIVE MORTGAGE INSTRUMENTS

SEC. 307. The first proviso in section 203(c) of the National Housing Act is amended by inserting after "fixed for insurance" the following: "(1) of mortgages pursuant to section 245, 247, 248, or 249, or pursuant to any other financing mechanism providing alternative methods for repayment of a mortgage which is determined by the Secretary to involve additional risk, or (2)".

MODIFICATION OF FHA DEBENTURE TERMS

SEC. 308. (a) Section 203(c) of the National Housing Act is amended by striking, in the second sentence, the phrase "at par plus accrued interest".

(b) Section 207(d) of such Act is amended by striking, in the first sentence the phrase ", at par plus accrued interest".

(c) Section 220(h) of such Act is amended by (1) striking in paragraph (5) the parenthetical phrase "(at par plus accrued interest)".

(d) Section 223(d) of such Act is amended by striking immediately before the period at the end of the fourth sentence the phrase "at par plus accrued interest".

DISCRETIONARY AUTHORITY TO REGULATE RENTS AND CHARGES

SEC. 309. (a) Section 207(b)(2) of the National Housing Act is amended by—

(1) striking out "any other mortgagor approved by the Secretary" and all that follows through "reasonable return on the investment." and inserting in lieu thereof the following: "any other mortgagor approved by the Secretary. The Secretary may, in the Secretary's discretion, require any such mortgagor to be regulated or restricted as to rents or sales, charges, capital structure, rate of return, and methods of operation so as to provide reasonable rentals to tenants and

a reasonable return on the investment. Any such regulations or restrictions shall continue for such period or periods as the Secretary, in the Secretary's discretion, may require, including until the termination of all obligations of the Secretary under the insurance and during such further period of time as the Secretary shall be the owner, holder, or reinsurer of the mortgage.";

(2) striking out "render effective the regulations or restrictions" and inserting in lieu thereof "render effective any such regulations or restrictions"; and

(3) striking out "and directed" in the second sentence of the first undesignated paragraph.

(b) Section 234(d)(2) of such Act is amended by—

(1) striking out "shall be regulated or restricted by the Secretary" and inserting in lieu thereof "may, in the Secretary's discretion, be regulated or restricted"; and

(2) striking out "the regulation and restriction" and inserting in lieu thereof "any such regulation or restriction".

MORTGAGE INSURANCE FOR MANUFACTURED HOME PARKS FOR THE ELDERLY

SEC. 310. The first sentence of the second undesignated paragraph of section 207(b) of the National Housing Act is

amended by striking out "no mortgage shall be insured hereunder" and inserting in lieu thereof the following: "the Secretary shall not insure any mortgage under this section (except a mortgage with respect to a manufactured home park designed exclusively for occupancy by elderly persons)".

INCREASED MORTGAGE LIMITS FOR SUBSTANTIAL REHABILITATION

SEC. 311. (a) Section 220(d)(3)(B)(ii) of the National Housing Act is amended by striking out "*Provided further,*", the first time it appears, and all that follows through "property or project:".

(b) Section 221(d)(3)(iii) of such Act is amended by—

(1) striking out "*Provided,* That" and all that follows through "property or project:"; and

(2) striking out "*further*" the first time it appears.

(c) Section 221(d)(4)(iv) of such Act is amended by—

(1) striking out "*Provided,* That" and all that follows through "property or project:"; and

(2) striking out "*further*" the first time it appears.

ASSIGNMENT OF SECTION 221(g)(4) MORTGAGES TO THE GOVERNMENT NATIONAL MORTGAGE ASSOCATION

SEC. 312. Section 221(g)(4) of the National Housing Act is amended by inserting "(A)" after the paragraph designation "(4)" and by adding the following new subparagraph at the end thereof:

"(B) In processing a claim for insurance benefits under this paragraph, the Secretary is authorized to direct the mortgagee to assign, transfer and deliver the original credit instrument and the mortgage securing the same directly to the Government National Mortgage Association in lieu of assigning, transferring and delivering the credit instrument and the mortgage to the Secretary. Upon the assignment, transfer and delivery of the credit instrument and the mortgage to the Association, the mortgage insurance contract shall terminate and the mortgagee shall receive insurance benefits as provided in subparagraph (A). The Association is authorized to accept such loan documents in its own name and to hold and service such loans as agent for the Secretary. The mortgagor's obligation to pay a service charge in lieu of a mortgage insurance premium shall continue as long as the mortgage is held by the Association or by the Secretary. The Secretary shall have the same authority with respect to mortgages assigned to the Secretary or the Association under this subparagraph as provided by section 223(c).".

TERMINATION OF SECTION 221 BUY-BACK PROVISION

SEC. 313. The first sentence of section 221(g)(4)(A) of the National Housing Act, as redesignated by section 312 of this Act, is amended by inserting immediately after "this sec-

tion" the following: "pursuant to a commitment to insure entered into before the effective date of the Housing and Community Development Amendments of 1982".

MORTGAGE INSURANCE FOR CONDOMINIUMS

SEC. 314. The first sentence of section 234(c) of the National Housing Act is amended by striking out "(2) the project" and all that follows through "and (3)" and inserting in lieu thereof "and (2)".

REMOVAL OF RESTRICTION ON FEDERAL HOUSING ADMINISTRATION COINSURANCE

SEC. 315. Section 244(d) of the National Housing Act is amended by striking out the second and third sentences.

ALTERNATIVE MORTGAGE INSTRUMENTS

SEC. 316. (a) Section 245 of the National Housing Act is amended by—

(1) striking out subsections (a) and (b) and inserting in lieu thereof the following:

"SEC. 245. (a) The Secretary may insure under any provision of this title mortgages and loans with provisions of varying rates of amortization corresponding to anticipated variations in family or, as appropriate, project income, to the extent the Secretary determines such mortgages or loans (1) have promise for expanding housing opportunities or meet special needs, (2) can be developed to include any safeguards for mortgagors, tenants or purchasers that may be necessary

to offset special risks of such mortgages, and (3) have a potential for acceptance in the private market. A mortgage or loan may not be insured pursuant to this section after September 30, 1984, except pursuant to a commitment entered into before that date.

"(b) Notwithstanding any other provision of this title, the principal obligation of a mortgage or loan insured pursuant to this section involving property upon which there is located a dwelling designed principally for occupancy by one to four families—

"(1) shall not initially exceed the percentage of the initial appraised value of the property specified in section 203(b) of this title as of the date the mortgage or loan is accepted for insurance; and

"(2) thereafter (including all interest to be deferred and added to principal) (A) shall not at any time be scheduled to exceed 97 per centum, or, if the mortgagor is a veteran, such higher percentage as is provided under section 203(b)(2) for veterans, of the projected value of the property, and (B) shall not exceed 113 per centum of the initial appraised value of the property.

"(c) Notwithstanding any other provision of this title, the principal obligation of a mortgage or loan insured pursu-

ant to this section involving property upon which there are located five or more dwelling units—

"(1) shall not initially exceed the percentage of value or replacement cost required by the provision under which the property is insured; and

"(2) thereafter (including all interest to be deferred and added to principal) shall not at any time be scheduled to exceed 100 per centum of the projected value of the property.

"(d) For purposes of this section, the Secretary shall calculate the projected value of the property by increasing the initial value of the property, as determined by the Secretary, at a rate not in excess of 2½ per centum per annum."; and

(2) redesignating subsection (c) as subsection (e).

(b) Title II of such Act is amended by adding at the end thereof the following new sections:

"ADJUSTABLE RATE SINGLE-FAMILY MORTGAGES

"SEC. 247. (a) The Secretary may insure under any provision of this title a mortgage involving property upon which there is located a dwelling designed principally for occupancy by one to four families, where the mortgage provides for periodic adjustments by the mortgagee in the effective rate of interest charged. These interest rate adjustments may be accomplished through adjustments in the monthly pay-

ment, the mortgage term, or a combination of these factors, except that in no case may any extension of a mortgage term result in a total term in excess of forty years. Adjustments in the effective rate of interest shall correspond to a specified national interest rate index approved in regulations by the Secretary, information on which is readily accessible from published sources. Adjustments in the effective rate of interest shall (1) be made on an annual basis; (2) be limited, with respect to any single interest rate increase, to no more than 1 per centum per annum on the outstanding loan balance; and (3) be limited to a maximum increase of 5 percentage points above the initial contract interest rate over the term of the mortgage. A mortgage may not be insured pursuant to this section after September 30, 1984, except pursuant to a commitment entered into before that date.

"(b) The Secretary shall issue regulations requiring that the mortgagee make available to the mortgagor, at the time of loan application, a written explanation of the features of the adjustable rate mortgage, including, but not limited to, a hypothetical payment schedule which displays the maximum potential increases in monthly payments to the mortgagor over the first five years of the mortgage term.

"(c) The number of mortgages and loans insured pursuant to this section in any fiscal year may not exceed one hundred and twenty-five thousand mortgages.

"SHARED APPRECIATION MORTGAGES—SINGLE FAMILY

"SEC. 248. (a) Notwithstanding any provision of this title which is inconsistent with this section, the Secretary may insure, under any provision of this title providing for insurance of mortgages on properties upon which there is located a dwelling designed principally for occupancy by one to four families, a mortgage secured by a first lien on the property which (1) provides for the mortgagee to share in a predetermined percentage of the property's net appreciated value and (2) meets such other conditions, including limitations on the rate of interest which may be charged, as the Secretary may require by regulation. A mortgage may not be insured pursuant to this section after September 30, 1984, except pursuant to a commitment entered into before that date.

"(b) The mortgagee's share of a property's net appreciated value shall be payable upon sale or transfer (as defined by the Secretary) of the property or payment in full of the mortgage, whichever occurs first. For purposes of this section, the term 'net appreciated value' means the amount by which the sales price of the property (less the mortgagor's selling costs) exceeds the value of the property at the time the commitment to insure is issued (with adjustments for capital improvements stipulated in the loan contract). If there has been no sale or transfer at the time the mortgagee's share of net appreciated value becomes payable, the sales

price for purposes of this section shall be determined by means of an appraisal conducted in accordance with procedures approved by the Secretary and provided for in the mortgage.

"(c) In the event of a default, the mortgagee shall be entitled to receive the benefits of insurance in accordance with section 204(a) of this title, but such insurance benefits shall not include the mortgagee's share of net appreciated value. The term 'original principal obligation of the mortgage' as used in section 204 shall not include the mortgagee's share of net appreciated value.

"(d) The Secretary shall establish by regulation the maximum percentage of net appreciated value which may be payable to a mortgagee as the mortgagee's share. The Secretary shall also establish disclosure requirements applicable to mortgagees making mortgage loans pursuant to this section, to assure that mortgagors are informed of the characteristics of such mortgages.

"(e) Mortgages insured pursuant to this section which contain provisions for sharing appreciation or which otherwise require or permit increases in the outstanding loan balance which are authorized under this section or under applicable regulations shall not be subject to any State constitution, statute, court decree, common law, rule or public policy

limiting or prohibiting increases in the outstanding loan balance after execution of the mortgage.

"(f) The number of mortgages insured pursuant to this section in any fiscal year may not exceed fifty thousand.

"SHARED APPRECIATION MORTGAGES—MULTIFAMILY

"SEC. 249. (a) Notwithstanding any provision of this title which is inconsistent with this section, the Secretary may insure, under any provision of this title providing for insurance of mortgages on properties including five or more family units, a mortgage secured by a first lien on the property which (1) provides for the mortgagee to share in a predetermined percentage of the property's net appreciated value and (2) meets such other conditions, including limitations on the rate of interest which may be charged, as the Secretary may require by regulation. A mortgage may not be insured pursuant to this section after September 30, 1984, except pursuant to a commitment entered into before that date.

"(b) The mortgagee's share of a property's net appreciated value shall be payable upon maturity or upon payment in full of the loan or sale or transfer (as defined by the Secretary) of the property, whichever occurs first. The term of the mortgage shall not be less than fifteen years, and shall be repayable in equal monthly installments of principal and fixed interest during the mortgage term in an amount which would be sufficient to retire a debt with the same principal and fixed

interest rate over a period not exceeding thirty years. In the case of a mortgage which will not be completely amortized during the mortgage term, the principal obligation of the mortgage may not exceed 85 per centum of the estimated value of the property or project. For purposes of this section, the term 'net appreciated value' means the amount by which the sales price of the property (less the mortgager's selling costs) exceeds the value (or replacement cost, as appropriate) of the property at the time the commitment to insure is issued (with adjustments for capital improvements stipulated in the loan contract). If there has been no sale or transfer at the time the mortgagee's share of net appreciated value becomes payable, the sales price for purposes of this section shall be determined by means of an appraisal conducted in accordance with procedures approved by the Secretary and provided for in the mortgage.

"(c) In the event of a default, the mortgagee shall be entitled to receive the benefits of insurance in accordance with section 207(g) of this title, but such insurance benefits shall not include the mortgagee's share of net appreciated value. The term 'original principal face amount of the mortgage' as used in section 207(g) shall not include the mortgagee's share of net appreciated value.

"(d) The Secretary shall establish by regulation the maximum percentage of net appreciated value which may be

payable to a mortgagee as the mortgagee's share. The Secretary shall also establish disclosure requirements applicable to mortgagees making mortgage loans pursuant to this section, to assure that mortgagors are informed of the characteristics of such mortgages.

"(e) Mortgages insured pursuant to this section which contain provisions for sharing appreciation or which otherwise require or permit increases in the outstanding loan balance which are authorized under this section or under applicable regulations shall not be subject to any State constitution, statute, court decree, common law, rule or public policy limiting or prohibiting increases in the outstanding loan balance after execution of the mortgage.".

(c) The first sentence of the first undesignated paragraph of section 207(c)(3) of such Act is amended by inserting immediately after "periodic payments" the following: "(unless otherwise approved by the Secretary)".

(d) Section 220(d)(4) of such Act is amended by inserting after "periodic payments" the following: "(unless otherwise approved by the Secretary)".

(e) Section 221(d)(6) of such Act is amended by inserting after "periodic payments" the following: "(unless otherwise approved by the Secretary)".

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(f) Section 231(c)(5) of such Act is amended by inserting after "periodic payments" the following: "(unless otherwise approved by the Secretary)".

STRUCTURAL DEFECTS IN INSURED PROPERTY

SEC. 317. Section 518(a) of the National Housing Act is amended by striking out "approved for mortgage insurance prior to the beginning of construction which he finds" and inserting in lieu thereof the following: "which, before the beginning of construction, was approved for mortgage insurance under this Act or for guaranty, insurance, or a direct loan under chapter 37 of title 38, United States Code, and which the Secretary finds".

TIME OR PAYMENT OF PREMIUM CHARGES

SEC. 318. Section 530 of the National Housing Act is amended by—

(1) striking out "promptly upon their receipt from the borrower" and inserting in lieu thereof the following: "(A), in the case of loans or mortgages respecting one- to four-family residences, promptly upon their receipt from the borrower and (B), in any other case, promptly when due to the Secretary";

(2) inserting "or due date, as appropriate," immediately after "such receipt"; and

(3) inserting "or after the due date, as appropriate," immediately before "and ending".

SINGLE-FAMILY MORTGAGE INSURANCE ON INDIAN RESERVATIONS

SEC. 319. Title V of the National Housing Act is amended by adding the following new section at the end thereof:

"SINGLE-FAMILY MORTGAGE INSURANCE ON INDIAN RESERVATIONS

"SEC. 533. (a) The Secretary, subject to such special conditions as the Secretary may prescribe, is authorized to insure under any provision of title II of this Act which authorizes such insurance, a mortgage covering a property upon which there is located a one- to four-family residence, without regard to limitations in this Act relating to marketability of title or any other statutory restriction which the Secretary determines is contrary to promoting the availability of such insurance on Indian reservations if—

"(1) the mortgage is executed by a member of an enrolled Indian tribe, who will use the property as a principal residence; and

"(2) the property is located on an Indian reservation.

Notwithstanding any other provision of this Act, the insurance of a mortgage using the authority contained in this section shall be the obligation of the General Insurance Fund created pursuant to section 519 of this Act.

"(b) As used in this section—

"(1) the term 'Indian tribe' means any Indian or Alaska native tribe, band, nation, or other organized group or community of Indians or Alaska Natives recognized as eligible for the services provided to Indians or Alaska Natives by the Secretary of the Interior because of their status as Indians or Alaska Natives; and

"(2) the term 'Indian reservation' means (A) that area of land, as defined by the Secretary of the Interior, over which an Indian tribe is recognized by the United States as having governmental jurisdiction, (B) Indian tribal land, or (C) land acquired by Alaska Natives under the Alaska Native Claims Settlement Act or any other land acquired by Alaska Natives pursuant to statute by virtue of their unique status as Alaska Natives.".

PROPERTY DISPOSITION AND RELATED AMENDMENTS

SEC. 320. (a) The caption of section 203 of the Housing and Community Development Amendments of 1978 is amended to read as follows:

"DISPOSITION OF HUD-OWNED MULTIFAMILY HOUSING PROJECTS".

(b) Section 203 of such Act is amended to read as follows:

"SEC. 203. Whenever tenants of any multifamily rental housing project owned by the Secretary of Housing and Urban Development (the "Secretary") will be displaced, the Secretary shall notify all affected tenants of their pending displacement and of any relocation assistance which may be available. The Secretary is authorized to provide assistance in accordance with section 8(b)(3)(B) of the United States Housing Act of 1937 to very low-income families, as defined in that Act, who are tenants of a multifamily project owned by the Secretary which, prior to acquisition by the Secretary, was (1) subject to a loan under section 202 of the Housing Act of 1959 and not assisted under section 8 of the United States Housing Act of 1937 or (2) assisted under section 236 or the proviso of section 221(d)(5) of the National Housing Act, or section 101 of the Housing and Urban Development Act of 1965, and insured under the National Housing Act.".

(c) Title V of the National Housing Act is amended by adding the following new section at the end thereof:

"PARTIAL PAYMENT OF INSURANCE CLAIMS

"SEC. 534. Notwithstanding any other provision of law, whenever the Secretary is requested to accept assignment of a mortgage insured by the Secretary under this Act which covers a multifamily housing project, and the Secretary determines that partial payment would be less costly to the Federal Government, the Secretary may request the mort-

gagee, in lieu of assignment, to accept partial payment of the claim under the mortgage insurance contract and to recast the mortgage, under such terms and conditions as the Secretary may determine. As a condition to a partial claim payment under this subsection, the mortgagor shall agree to repay to the Secretary the amount of such payment and such obligation shall be secured by a second mortgage on the property on such terms and conditions as the Secretary may determine.".

(d) Section 367 of the Multifamily Mortgage Foreclosure Act of 1981 is amended by—

(1) striking out "SEC. 367. (a)" and inserting in lieu thereof "SEC. 367."; and

(2) striking out subsection (b).

PREVENTION OF FRAUD AND ABUSE IN HUD-ASSISTED PROGRAMS

SEC. 321. (a) The Secretary may require, as a condition of initial or continuing eligibility for participation in any program of the Department involving loans, grants, interest subsidies, other financial assistance of any kind, or mortgage or loan insurance, that—

(1) an applicant, including members of an applicant's household if the Secretary so requires, include his or her social security account number or em-

ployer identification number on forms designated by the Secretary; and

(2) an applicant, including members of an applicant's household if the Secretary so requires, sign a consent form designated by the Secretary authorizing the Secretary to verify and audit the information furnished by the applicant and authorizing other governmental agencies and private sources (with such reimbursement as may be agreed upon) to release information related to the initial determination of eligibility and/or benefit level or postverification thereof. Such information may include, but is not limited to, data concerning wages, unemployment compensation, and data relating to benefits made available under the Social Security Act, the Food Stamp Act of 1977, or title 38, United States Code. Any such information received pursuant to this subsection shall remain confidential except for use pursuant to this section as determined by the Secretary, including but not limited to determining or thereafter verifying an applicant's eligibility or the benefit level to be provided.

As used in this subsection, the term "applicant" shall have such meaning as the Secretary by regulation shall prescribe.

(b) Section 303(d)(1) of the Social Security Act is amended by—

(1) inserting in subparagraph (A) after "Department of Agriculture" the following: "or the Department of Housing and Urban Development,"; and inserting after "food stamp agency" the following: "or any public housing agency,"; and

(2) inserting in subparagraph (B) after "Food Stamp Act of 1977" the following "and the programs of the Department of Housing and Urban Development".

For purposes of this subsection, the term "public housing agency" means any agency described in section 3(b)(6) of the United States Housing Act of 1937.

(c) Notwithstanding any other provision of law, the entity responsible for determining eligibility and/or level of benefits under the United States Housing Act of 1937, section 101 of the Housing and Urban Development Act of 1965, or section 221(d)(3) or 236 of the National Housing Act, including public housing agencies as defined in section 3(b)(6) of the United States Housing Act of 1937 and owners of projects assisted under such programs, shall deny applicants for or participants in such programs eligibility in, and/or benefits of, the particular program if it determines that an applicant or participant has knowingly and willfully (1) made false or misleading statements, or misrepresented, concealed or withheld relevant facts in connection with such application

or participation, or (2) committed any action which constitutes a violation of these Acts or regulations issued thereunder. Unintentional error or omission on the part of applicants or participants in HUD programs shall not be a basis for denying eligibility unless, on the basis of accurate and complete information, the applicants or participants would be currently ineligible.

(d) Section 214(b) of the Housing and Community Development Act of 1980 is amended by striking out all that follows "1937" through "National Housing Act," and inserting in lieu thereof the following: "; section 221(d)(3), section 235, or section 236 of the National Housing Act;".

AMENDMENT OF REAL ESTATE SETTLEMENT PROCEDURES ACT OF 1974

SEC. 322. (a) Sections 8, 9, 13, 14, 15, and 16 of the Real Estate Settlement Procedures Act of 1974 are hereby repealed.

(b) Section 2(b) of such Act is amended by—

(1) adding "and" at the end of paragraph (1);

(2) striking out paragraphs (2) and (4) and redesignating paragraph (3) as paragraph (2); and

(3) striking out "; and" at the end of paragraph (2), as redesignated by this subsection, and inserting in lieu thereof a period.

(c) Section 3 of such Act is amended by striking out paragraphs (2) and (4) and redesignating the remaining paragraphs accordingly.

(d) Section 4(b)(2) of such Act is amended by striking out the last sentence.

(e) Section 5(a) of such Act is amended by inserting "the text of" following "distribute" where it appears in the first and second sentences thereof.

(f) Section 10 of such Act is amended by inserting after "twelve-month period" in paragraph (1) the following: ": *Provided*, That a lender may require deposit of a sum sufficient to pay taxes, insurance premiums or other charges with respect to the property when each such charge is next due, without regard to the procedure set forth above, if that procedure does not provide a sufficient sum to satisfy each such obligation".

(g) Section 12 of such Act is amended by striking out "sections 4 and 6" and inserting in lieu thereof "section 4".

HOUSING COUNSELING ASSISTANCE

SEC. 323. (a) Section 106(a)(1) of the Housing and Urban Development Act of 1968 is amended by striking out ", or contract with public or private organizations to provide,".

(b) Section 106(a)(2) of such Act is amended to read as follows:

"(2) The Secretary is authorized to provide information, advice, and technical assistance to private and public organizations with special competence and knowledge in counseling low- and moderate-income families to assist such organizations in providing the counseling and advice described in clause (iii) of paragraph (1) of this subsection.".

(c) Sections 101(e) and 106(a)(3) of such Act are hereby repealed.

(d) Section 230(d) of the National Housing Act is hereby repealed.

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SECTION-BY-SECTION EXPLANATION AND JUSTIFICATION

TITLE I -- COMMUNITY AND NEIGHBORHOOD DEVELOPMENT

RENTAL REHABILITATION

Section 101 would amend title I of the Housing and Community Development Act of 1974 to create a new Rental Rehabilitation Program. This new initiative will help preserve the Nation's rental housing stock in low- and moderate-income neighborhoods and assist very low-income tenants. The need for rental rehabilitation is clear: of 26 million renter-occupied units in the Nation, 1.8 million are seriously deficient and another 2.6 million have significant inadequacies. Furthermore, continuing deterioration and abandonment of rental units is accelerating the decline of many urban neighborhoods.

In order to provide low-income housing assistance at a fraction of previous costs, the Department proposes to rely primarily on the Modified Section 8 Existing Housing Program to bridge the "affordability gap" for very low-income renters in the private market. To ensure that the modified certificate approach works smoothly, a supporting program to rehabilitate rental units is necessary. The Rental Rehabilitation Program will answer the concern expressed by some that certificate assistance will be inadequate because affordable units will not be available to certificate holders. By providing States and local governments

with the ability to produce modestly rehabilitated units where needed, the new initiative will minimize the occurrence of localized rental unit shortages which may otherwise occur within some markets and neighborhoods.

The proposed Rental Rehabilitation Program addresses the need to upgrade rental properties through allocations to larger cities, urban counties, and States of both cash grants (Rental Rehabilitation Grants) and contract authority for rental assistance payments for tenants (Modified Section 8 Existing Housing). The new initiative would replace HUD's current Section 312 Rehabilitation Loan and Section 8 Moderate Rehabilitation Programs.

(1) Rental Rehabilitation Grants, allocated on a needs basis, would be used by local and State governments to help reduce owners' costs of rehabilitating rental properties in low- and moderate-income neighborhoods. This reduced-cost financing would make rehabilitation feasible in those areas where the after-rehabilitation, free-market rent for units will be affordable to persons receiving rental assistance through Modified Section 8 Existing Housing.

(2) Modified Section 8 Existing Housing ("modified certificates") would offer very low-income tenants the opportunity to lease rehabilitated units and other standard housing stock at rental payments which they can afford. Contract

authority for certificates would be allocated for local and State governments in the same proportion as their rental rehabilitation grants.

Program funds are to be used in low- and moderate-income neighborhoods, selected according to locally established criteria. Grants to local and State governments will have no restrictions regarding the number of units in buildings to be assisted; unlike previous HUD programs, no distinction is made between single family and multifamily properties. All structures and units must meet the Section 8 Existing Housing Quality Standards after rehabilitation. Local and State governments are given broad discretion in providing rental rehabilitation funds to individual property owners. For example, public monies may be given as outright grants (reducing the rehabilitation funds which property owners need to obtain from private sources), deferred payment loans (to be repaid on sale of the building), or low-interest loans repayable to the public agency.

In order to encourage a high level of participation by private lenders in project financing and underwriting, assistance provided under the new program may not exceed 50 percent of the cost of rehabilitating each individual property. If additional public funds are needed to meet local and State program objectives, Community Development Block Grants or other public monies may be used to further assist individual projects.

A key feature of the new program is the separation of the rehabilitation and rental subsidies, and a reliance on private market forces to encourage owner participation and availability of rehabilitated units for very low-income families. Unlike HUD's current Section 8 Moderate Rehabilitation Program, the Rental Rehabilitation Program would not require property owners receiving assistance to agree to rent limitations and guaranteed low-income occupancy imposed by government in connection with the program. Instead, a program performance standard would encourage participating governments to select neighborhoods and properties in which eighty percent of initial after-rehabilitation market rents (i.e., rents without special program rent limits) will fall below the applicable payment standard for modified certificates, and thus be affordable to very low-income tenants holding certificates.

Consistent with the general rules of the Modified Section 8 Existing Housing Assistance Program, tenants receiving certificates under the rental rehabilitation initiative may live in units of their choice. Thus, they may elect to remain in units rehabilitated under the program or to move to any other dwelling of their choice. This means that long-term, low-income occupancy in rehabilitated structures is not guaranteed through the new program. However, the performance standard on after-rehabilitation rents mentioned above would push rental rehabilitation activity into areas where such rents are most

likely to continue to be affordable by very low-income renters with modified certificates and low- and moderate-income families and individuals without certificates.

The program separation between rehabilitation and rental subsidies will have fundamental implications for financial underwriting and management of individual structures. Since certificate holders in assisted properties may move out of their units at any time, subject to any lease requirements, owners cannot depend on a HUD-guaranteed rental income stream. Instead, property financial underwriting, including repayment of rehabilitation debt, has to make sense even if buildings have no certificate holders renting units. Real market rents--rents which unsubsidized tenants are actually willing to pay for rehabilitated units in the areas where assisted structures are located--would serve as the basis for the underwriting of rehabilitation projects supported by this program.

It is anticipated that local and State governments, interested in stretching the impact of their rental rehabilitation funds, will generally limit the amount of assistance to each individual project to the minimum amount needed to make the project work.

Since this program does not provide for guaranteed tenants and/or subsidies attached to individual units, property owners must work to keep current tenants satisfied and, if vacancies

occur, to attract new renters. Thus, owners will be under market place pressure to maintain building services and conditions once rehabilitation is completed.

In short, the proposed rental rehabilitation program brings the free market place back into HUD's assisted housing programs. As a result of this fundamental shift in approach, the Federal Government will be able to assist a significantly larger number of property owners and very low-income tenants than current programs could for the same amount of money. Analysis shows that the proposed Rental Rehabilitation Program can provide comparable assistance to that provided under the Section 8 Moderate Rehabilitation Program to 40 percent more families and to 40 percent more units at the same cost.

Specific provisions of the proposal are as follows. Subsection (a) provides basic authorization to the Secretary to make rental rehabilitation grants to States and units of general local government. Grants would be made available to help support the rehabilitation of privately owned real property to be used for primarily residential rental purposes. Up to $150 million of amounts appropriated under title I of the 1974 Act for FY 1983 would be available for rental rehabilitation grants in that year.

Subsection (a) would also authorize HUD to make available contract authority under the Modified Section 8 Existing Housing Program for use in connection with rental rehabilitation

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programs. The special allocations of these certificates are expected to be used primarily to enable tenants of structures to be upgraded under the program to remain in their units after rehabilitation. However, these certificates may also be used to assist tenants displaced as the result of rehabilitation activities and to implement the more general purposes of the Modified Section 8 Existing Housing Assistance Program, i.e., to assist other very low-income tenants in obtaining decent, safe, and sanitary housing. For example, certificates could be given to qualified families on Section 8 waiting lists with referral to vacant units rehabilitated with program funds.

Subsection (b) establishes provisions for the allocation and reallocation of resources provided under the new section. Paragraph (1) makes cities with populations of 50,000 or more, urban counties (as defined under title I of the Housing and Community Development Act of 1974), and States eligible for rental rehabilitation grants. The Secretary would allocate amounts, taking into account such factors as low-income renter population, rental housing market conditions, overcrowding of rental housing, the condition of the rental housing stock, and other appropriate objectively measurable conditions. These factors are intended to assure that program funds are targeted to areas of greatest need. The actual allocation system will be determined once relevant 1980 Census data are available.

Paragraph (2) gives the Secretary authority to make several key adjustments in the allocation amounts established under paragraph (1). First, the Secretary may establish minimum allocation amounts for grants to cities and urban counties representing program levels below which conduct of a local program would not be feasible. HUD is currently planning a minimum allocation amount of $100,000 which would generate a program volume of at least $200,000 (due to the 50% leveraging requirement). Funding "allocations" of less than the minimum amounts would be added to the allocation for the States where the relevant cities and counties are located, and these localities would be eligible for assistance from the States in undertaking rental rehabilitation activities.

Second, the Secretary is authorized to make annual performance adjustments, not to exceed 15 percent in amounts added or deducted, to city, urban county, and State allocations, based on an annual review of each grantee's progress in meeting program performance requirements. The Secretary would establish program performance criteria, including performance in achieving the result that at least 80 percent of the initial after-rehabilitation rents for assisted properties, on a free-market basis, are within the applicable payment standard for modified certificates. If a city or urban county qualifies for a direct allocation of funds above the minimum program amount, it

would receive a grant even if this performance adjustment reduces the grant below the minimum level.

Paragraph (3) provides for allocation of contract authority for modified certificates for grantees on a basis proportional to the allocation of rental rehabilitation grant funds. It also authorizes the Secretary to include a provision in the annual contributions contracts for these certificates to ensure that use of the rental rehabilitation grants and modified certificates is effectively coordinated.

Paragraph (4) authorizes the Secretary to make annual program reviews and audits of local and State efforts to ensure that grant recipients are carrying out their activities in a timely manner and consistent with program guidelines, and that they have a continuing capacity to carry out the program in a timely manner. This paragraph also authorizes the Secretary to adjust, reduce, or withdraw resources made available under the program, with the limitation that resources already expended on eligible activities may not be recaptured or deducted from future resources to be made available. Resources which become available as a result of these funding adjustments (and actions under section 111 of the 1974 Act) are to be reallocated to other States and localities during the year in which they become available. These review and grant adjustment features are

comparable to those in the Community Development Block Grant Program.

Paragraph (5) authorizes the Secretary to establish the maximum levels of rental rehabilitation grants which individual governments may receive in a single year under the program. Although States and localities with effective programs may receive funds above their initial allocations, their receipt of funding reallocations will have an upper limit. This provision will minimize the incentive for local governments to overstaff or spend funds too quickly in a "grantsmanship" effort to get more funds.

Paragraph (6) provides that funds not obligated by States and localities to specific projects at the end of a fiscal year will be added to funds available for the general allocation in the next year under subsection (b).

The rental rehabilitation program would not require participating governments to submit an application before receiving annual funds. Subsection (c) does, however, require program participants to prepare an annual statement containing a description of their rental rehabilitation programs by December 31 of each year in which activities are being carried out. Copies of the statement would be made available to the public and submitted to HUD.

Subsection (d) contains a series of key program requirements. Paragraph (1) provides that rental rehabilitation grants can only be used to rehabilitate structures which are located in low- and moderate-income areas defined and designated by the grant recipient and which are to be used primarily for residential rental purposes. Paragraphs (2) and (3) establish the requirements that all assisted rehabilitation meet the section 8 Housing Quality Standards, and that program funds only cover 50 percent of project rehabilitation costs, as defined by the Secretary. Paragraph (4) prohibits participating governments from imposing special rental limitations on property owners assisted with rental rehabilitation funds. The rental of units in properties rehabilitated under the program would be subject to the same State and local requirements as any comparable rehabilitation undertaken without Federal assistance. This feature is crucial to the cost-efficient, market-based characteristic of the Rental Rehabilitation Grant Program.

Paragraph (5) prohibits owners of structures assisted with program funds from refusing to rent to tenants solely because they are receiving Section 8 rental assistance. Paragraph (6) requires participating jurisdictions, in designing and operating their programs, to require property owners to be personally liable for payment of debts incurred. This provision is designed to encourage an increased sense of owner responsibility for individual assisted projects during and after rehabilitation. It

will also tend to encourage program participation by owners with a greater interest in long-term rental income rather than the syndication of tax benefits.

Paragraph (7) prohibits States and localities from using program funds for the costs of administering their rental rehabilitation efforts. Localities and States are expected to use Community Development Block Grant or other public funds to support the administrative costs of operating their rental rehabilitation programs.

Subsection (e) contains provisions relating to State rental rehabilitation programs. Paragraph (1) limits State use of rental rehabilitation resources to jurisdictions and unincorporated areas which do not receive direct allocations under subsection (b). States may either establish their own programs, working directly with property owners in the eligible areas, and/or distribute the resources to individual jurisdictions. In order to give States time to gear up for the program, States would be able to opt not to administer a rental rehabilitation program in fiscal year 1983. HUD will administer the State's allocations during 1983 in any State exercising this option. After fiscal year 1983, States will be expected to assume responsibility for administering their programs.

Subsection (f) gives the Secretary authority to establish by regulation relocation standards for the new program. These rules

will only apply to the fiscal year 1983 HUD-operated State program, as provided for in subsection (e).

Subsection (g) provides that program participants will be responsible for supporting national historic preservation objectives in their rental rehabilitation efforts, working with State Historic Preservation Officers on any projects where national historic preservation standards cannot be met. It also exempts the new program from provisions of the National Environmental Policy Act and other related laws and authorities.

Section 101(b) would exempt rental rehabilitation grants from the "lump sum" drawdown provisions of section 104(g). Subsection (c) contains a technical, conforming amendment. Subsection (d) would require program grantees to certify in advance of funding that their programs will be conducted and administered in conformity with applicable civil rights requirements.

URBAN HOMESTEADING

Section 102(a) would reduce the fiscal year 1983 funding authorization for the urban homesteading program from $13.467 million to $12 million, and would authorize the appropriation of such sums as may be necessary for the program for fiscal year 1984.

Of the $12 million requested, $9 million would be used for the existing urban homesteading program. This represents a program level sufficient to meet anticipated program demand for fiscal year 1983. The remaining $3 million would be used to carry out the Multifamily Homesteading Demonstration Program proposed in subsection (c).

Subsection (b) contains a series of amendments to permit HUD and the governmental entities carrying out urban homesteading programs to charge consideration in connection with the transfer of homestead properties to the entities and to the ultimate owner-occupants, respectively. Existing law requires HUD to transfer properties to local entities without payment, and requires conveyance of the property to the homesteader to be "without substantial consideration." If the consideration received for a property by a local entity exceeds that charged by HUD for the property, half of the excess would have to be remitted to HUD.

These amendments recognize the fact that free transfer is not always necessary to successful homesteading. Thus, HUD would be given discretionary authority to set a transfer price for individual homesteading properties at a level conducive to attract homesteaders, while at the same time stretching scarce Federal resources over more homesteading properties. States and localities would be free to charge whatever consideration they

deem appropriate for these properties, with the caveat that half of their "gain" would have to be refunded to HUD.

Subsection (c) would authorize HUD to demonstrate the feasibility and desirability of using a variety of homesteading and related techniques to encourage the reuse of HUD-owned multifamily properties for primarily residential use, in which the dwelling units would be under a cooperative or condominium form of ownership. The Secretary would transfer suitable properties to the State or local government, which would be responsible for managing the disposition and rehabilitation of the property at the local level. The transfer would include such terms and conditions as would be agreed between the Secretary and the responsible agency, including the right of the Secretary to assure that such use in fact occurs.

The program would be designed to spur local interest in dealing with deteriorated multifamily housing stock in creative and innovative ways. Among other things, HUD would encourage new approaches to multifamily homesteading, such as "condosteading". "Condosteading" would permit homesteaders to build equity, and could be used to encourage people of middle income to invest and live in deteriorated buildings and neighborhoods. HUD would also encourage creative financing techniques for rehabilitation, which would result in the maximum leverage of public funds.

The Multifamily Homesteading Program would concentrate on the transfer of properties with approximately 30 units (to the extent available), to coincide with the precepts of the proposed Rental Rehabilitation Program. This would also allow for the transfer of a greater number of properties.

The Budget assumes participation by up to 15 localities and the transfer of at least 15 properties, with an average acquisition price of $200,000 (30 unit properties at $6,500 per unit average). Since the Department intends to vary the level of subsidy for property acquisition by requiring a down payment or equity commitment by the homestead entity, the total number of transfers could increase by as much as 50 percent.

Finally, the proposal would authorize the use of homesteading funds for technical assistance in connection with the demonstration program.

REPEALERS

Section 103 would repeal several HUD community development and related authorities. Subsection (a) would repeal the Rehabilitation Loan Program contained in section 312 of the Housing Act of 1964. This Program authorizes direct loans to property owners and tenants to finance the rehabilitation of residential and business properties.

These functions are eligible for funding under a number of existing eligible activities in the Community Development Block Grant Program. For example, section 105(a)(4) includes as an eligible activity the rehabilitation of buildings and improvements, including the financing of public or private acquisition of privately owned properties for rehabilitation and the rehabilitation of those properties. Section 105(a)(14) provides that block grants may be used, among other things, to finance the rehabilitation of commercial or industrial buildings or structures and other commercial or industrial real property improvements. Finally, section 105(a)(15) allows block grants to be used for a wide range of rehabilitation activities undertaken by neighborhood nonprofit groups, local development corporations and minority-enterprise small business investment companies. In addition, special funding for rental rehabilitation is proposed in the Department's Rental Rehabilitation Initiative. In light of these existing and proposed authorities, continuation of the Section 312 Program is no longer desirable.

The proposal would, however, retain provisions of section 312 concerning the creation and uses of the program's revolving fund. These provisions would be retained to insure that funds for servicing and liquidating section 312 loan contracts would be available until September 30, 1983 or until the assets and liabilities of the fund are transferred to the revolving fund for liquidating programs, whichever is earlier. An amendment to accomplish the transfer of the fund will be included in the Department's proposed fiscal year 1983

appropriation legislation. The provision also would make clear that the monies in the revolving fund for liquidating programs may be used for necessary expenses (including the use of private contractors) for servicing and liquidating section 312 loans.

Subsection (b) would repeal the Surplus Land Program contained in section 414 of the Housing and Urban Development Act of 1969. Section 414 permits the General Services Administration to transfer surplus Federal real property to HUD and the Department of Agriculture for sale or lease at fair value for use for predominantly low- and moderate-income housing.

Since its inception, this program has been infrequently used. Only seven properties have been transferred since 1970. This limited activity over such a long period does not justify the costs involved--staff, travel etc.--in maintaining the program. Moreover, the program is administratively inefficient, since it interjects HUD and FmHA between GSA and the ultimate purchaser/lessee of the property involved.

In addition to repealing section 414, this proposal would permit HUD and FmHA to dispose of surplus property within 120 days after the effective date of this Act if either Secretary had requested GSA to transfer the land prior to the effective date of this Act. This is necessary to assure that adequate time is afforded the Secretaries to complete processing of projects in the pipeline at the time of enactment of the 1983 legislation.

Section 414 presently provides that land conveyed to a private entity will revert to the United States if it is used for other purposes within 30 years (20 years with Federal approval) after its transfer for use as low- and moderate-income housing. The repealer specifically provides that this provision will continue to be in force and effect for all properties transferred pursuant to section 414 to which it applies.

Subsection (c) would repeal provisions of the Urban Renewal, Open Space Land and Neighborhood Facilities Programs in order to reduce Federal involvement in decisions which are more appropriately made at the local level.

Paragraph (1) of subsection (c) would repeal section 106(g) of the Housing Act of 1949. This provision requires localities to obtain a transient housing study before an Urban Renewal Plan can provide for the construction of hotels or other transient housing in the Urban Renewal area. The study is to assure that there is a need for this type of housing in the area. This requirement would be deleted, since the decision concerning whether to permit transient housing is one that should be made by local authorities who are most familiar with local zoning and marketing conditions.

Paragraphs (2) and (3) of subsection (c) would eliminate provisions in the Open Space Land and Neighborhood Facilities Programs which prohibit the conversion of land or property obtained with assistance under the Programs for uses other than those intended at

the time the grant was made, without prior Federal approval. These changes would give the locality complete discretion in determining the appropriate use of its land or property, and would thereby promote the effort to decentralize the decisionmaking process and speed its return to local control. The locality in which the land and/or property is situated is best able to determine what is the most appropriate use of its resources and whether or not a conversion to another use is consistent with its needs and objectives.

Specific provisions to be repealed include:

--Section 703(d) of the Housing and Urban Development Act of 1965. This authority prohibits the Secretary from approving a conversion in the use of neighborhood facilities during a 20-year period following the grant, unless HUD finds that the conversion is in accordance with the then-applicable program of health, recreational, social, or similar community services in the area, and is consistent with comprehensive planning for the development of the community in which the facility is located.

--Section 704 of the Housing Act of 1961. This provision allows the Secretary to approve a conversion of open space land to other purposes only where HUD finds that (1) there is other comparable land available for substitution; (2) it is needed for orderly growth and development; and (3) it is in accord with the comprehensive plan for the urban area.

--Section 705 of the Housing Act of 1961, which requires prior approval by the Secretary of the Interior before open space land involving historic or architectural purposes can be converted for other uses.

--The second sentence of section 706 of the Housing Act of 1961, which gives the HUD Secretary general authority to deny approval of the conversion of land for which a grant was made to acquire interests to guide future urban development.

TITLE II -- HOUSING ASSISTANCE PROGRAMS

ALLOCATION AND USE OF ASSISTED HOUSING AUTHORITY

The Department's FY 1983 Budget for low-income housing programs consists of the following major elements:

-- $1.8 billion of budget authority for public housing modernization under the Comprehensive Improvement Assistance Program contained in section 14 of the United States Housing Act of 1937;

-- 10,000 units of Section 8 new and substantial rehabilitation for use with the section 202 Housing for the Elderly or Handicapped Program;

-- 106,615 units under the new Modified Section 8 Existing Housing Assistance Program contained in section 202 of this Act, broken down as follows:

60,615 certificates designated for the conversion of units now under the current Existing Housing Program, 30,000 certificates estimated to be used in conjunction with the Rental Rehabilitation Program proposed in section 101 of this Act, 10,000 certificates estimated to be used with the sale of HUD-held properties (Property Disposition), 5,000 certificates to be available to the tenants of those public housing units to be sold or demolished during the fiscal

year, 1,000 certificates to be available for those Section 8 New Construction contracts that are not renewed at the end of their five-year contract term; and

-- the conversion of 5,000 units of Section 23 Leased Housing to the present Section 8 Existing Program.

Since the entire program for fiscal year 1983 is proposed to be funded through recaptured authority, no additional authority under section 5(c) of the 1937 Act is being requested for that year. In order to implement the program, however, section 201 would repeal section 213(d) of the Housing and Community Development Act of 1974 and section 5(c)(2) and (3) of the 1937 Act.

Section 213(d) requires HUD to allocate housing assistance on the basis of the relative needs of different areas and communities so far as practicable, establishes the range of allocations for nonmetropolitan areas at not less than 20 nor more than 25 percent of the total amount of such assistance, limits the reallocation of funds outside States in which they were initially allocated, and contains the 15 percent Headquarters Reserve. Given the Department's proposed program for fiscal year 1983 and beyond, it makes little sense to retain section 213(d). That section specifically exempts Comprehensive Modernization Assistance from its coverage. Moreover, it is inconsistent with the proposed uses of the new Section 8 Modified

Certificate Program. Conversions of units assisted under other 1937 Act provisions to the new program and provision of assistance in connection with the Property Disposition Program bear no necessary relationship to an area's relative need or location; allocation of modified Section 8 assistance for use in the Rental Rehabilitation Program would be governed by a separate allocation process. To the extent an allocation system is needed for the relatively small number of section 202 units, an equitable procedure could be established administratively.

Section 5(c)(2) and (3) of the 1937 Act imposes, among other things, percentage limits on the amount of contract authority which can be used for new and substantially rehabilitated units as opposed to existing units for fiscal years 1981 and 1982. These provisions, if retained, could apply to recaptured and/or carryover funds from those years which are proposed to be used to carry out the 1983 program. Since the percentage and other requirements of these provisions are inconsistent with the Department's 1983 program, they should be repealed.

MODIFIED SECTION 8 EXISTING HOUSING ASSISTANCE PROGRAM

Section 202 would amend Section 8 of the United States Housing Act of 1937 to create a new component under the Section 8 Existing Housing Assistance Program intended to serve as the cornerstone of HUD's future assistance to needy households.

These amendments draw upon HUD's experience with the Experimental Housing Allowance Program (EHAP), and would improve upon the present Section 8 Existing "Finder's Keeper's" program in several important respects. Instead of providing maximum rent ceilings based upon published Fair Market Rents (FMR's), under the modifications a "payment standard" would be used, based on the rental cost in a particular area of modestly priced standard housing of various sizes and types. This standard would be used, in combination with appropriate data about family income, to determine the Federal subsidy amount to be provided. A family would be permitted to rent above the payment standard amount, but would not receive additional subsidy when it did so. At the same time, a family also would be permitted to rent below the payment standard amount (provided that the selected unit met prescribed housing quality standards) without reduction of the subsidy amount. The program thus contains a "shopper's incentive" which serves both to contain the inflationary impact on rents that is experienced in the current program and, more importantly, to permit assisted families the similar range of choice between housing and other needs that they would exercise if utilizing only their own money.

The absence of a maximum rent provision would have several beneficial effects:

-- Increased opportunities for families to improve their housing and neighborhoods. Although housing markets are complex, in general the price of rental housing can be viewed as a continuum reflecting quality and location. Thus, the present role of FMR's severely limits the opportunities families have to improve their housing and neighborhoods. Without a rent ceiling, families would be able to choose units in neighborhoods with less concentration of low-income residents, furthering the legislative goal of promoting economically mixed housing and the Departmental goal of increased opportunity for all people to live where they choose.

In the EHAP, which also did not have a rent ceiling feature, over half of the participating families chose units above the equivalent of FMR and paid the additional cost themselves. Families like these, who are willing to forego other consumer items in order to live in better units or in better neighborhoods, should be permitted to do so.

-- Greater equity among eligible families. Many families are now living in housing which costs more than the FMR for Section 8 Existing housing. The rent ceiling feature excludes these families from participating in the present Section 8 program, ironically, because of the high value they place on housing. (The Section 8 Research program has found that a few

families do downgrade their housing in order to get within the FMR.)

-- <u>Easing pressures on FMR's</u>. In the EHAP, rents of units followed the rents in the market at large. In the Section 8 Existing Housing Program, however, there is a heavy concentration of rents near the FMR. There are several reasons for the concentration, but a major cause is the search for units in the narrow band of housing just under the FMR. Another reason is the perception that if a unit is in the program it can be rented at FMR, even if it was previously rented below it. In a survey of Section 8 landlords, many stated that they raised their rents to meet the FMR. All of these factors have the effect of pushing rents in that segment of the market up to FMR.

Because rents are pushed up to FMR, or even above FMR's to the maximum exception rent, and because the effect of the ceiling is to exclude units above this limit from the program, the present system creates constant pressures for raising FMR's, or for authorizations to use exception rents.

Comparisons of rent changes for EHAP and Section 8 Existing Housing Program recipient families that <u>do not move</u> demonstrate the difference a ceiling makes. These families in Section 8 experienced an increase of 8 percent in rent. In EHAP, without the ceiling, similar families' rents increased on average less than 2 percent.

Under the new program, the monthly assistance payment available for a family would be the amount by which the area's payment standard exceeded 30% of the family's monthly adjusted income. This amount would be controlled only by a "minimum rent" exception providing that in no case may the assistance payment be more than the amount by which the actual rent for the dwelling unit (including amounts allowed for separately metered utilities) exceeds the higher of (1) 10% of the family's income or (2) the portion of any welfare assistance payment which is specifically designated to meet housing costs.

For example, assume a payment standard of $300 and a family with an adjusted monthly income of $400. Deducting $120 (30% of adjusted income) from the payment standard would provide the family with a maximum subsidy of $180 a month ($300-$120=$180). This $180 would be the actual subsidy payment, unless the "minimum rent" exception clause in the payment standard formula produces a lower figure. For example, assume that the family's (gross) income is $475.00 a month, and that the rent (including utilities paid by the tenant) for the family's chosen unit is $225 a month. Subtracting 10% of the family's income ($47.50) from unit rent would result in a figure of $177.50 ($225-$47.50=$177.50). Since this is less than the subsidy produced by the payment standard-based formulation, it would reduce the subsidy. In the [illegible] case, a [illegible] a month rent would call for the family's receipt of the full $180 monthly subsidy.

since the minimum rent calculation at that level ($230-$47.50) would equal $183.50, and thus the payment standard calculation, and not the minimum rent, would govern. In either of these cases, as is evident, it takes the selection of a unit whose actual rent is substantially below the payment standard before the minimum rent provision becomes applicable.

Generally, families paying <u>more</u> than the payment standard for rent will contribute more than 30% of their adjusted income to the gross cost of housing chosen by them. On the other hand, to the extent that a family chooses housing at a cost <u>below</u> the payment standard, the family's contribution will be reduced.

But a household which rents a unit below the payment standard would not have its <u>subsidy</u> reduced. The tenant would be able to keep all savings in connection with finding an acceptable unit at a cost below the amount of the subsidy plus the family's rent contribution. The proposal would thus provide the household with a strong incentive not to pay more for a unit than its market value. This "shopper's incentive" would, of course, be subject to and limited by the minimum rent provision.

The program would be administered by the public housing agencies which currently administer the Section 8 Existing Housing Program. These agencies include local housing authorities which also own public housing units, as well as State

and regional agencies and a number of other local public entities.

Under the new program, initial eligibility would be limited to households with incomes at or below 50% of area median family income. Families would continue to receive assistance until such time as income increased to the point where the subsidy was zero or until the end of the annual contributions contract term, whichever came first. However, an important exception is provided for families which were previously receiving assistance under the United States Housing Act of 1937. A family whose assistance is being converted to the new program from another Section 8 program, or a family in public housing whose unit is scheduled to be demolished, could qualify for assistance under the new program even though family income was above 50% of median, based on the family's previous qualification for assistance under the Act.

Families qualifying for assistance under the program will be able to select housing from among the existing private rental stock. In some circumstances (for example, in the Rental Rehabilitation Program) the family's receipt of a certificate may be based upon its occupancy of a particular housing unit which is being upgraded or rehabilitated with Federal assistance. Others may receive a certificate based on their occupancy of a unit in a formerly assisted project that HUD has had to acquire and resell.

In such circumstances, the family may be welcome to continue to occupy the same unit, receiving the benefit of the certificate and its subsidy. However, such a family would not be required to occupy that unit as a condition to the receipt of its certificate. The certificate could be used in connection with that unit, or for any other standard unit the family chooses.

The unit selected by the family would be subject to an initial inspection to assure that it met housing quality standards established by the Secretary, before any subsidy assistance could be provided under the program. Subsequent inspections would be made at least annually to assure that the unit continues to meet such standards; otherwise the subsidy would be discontinued unless the family moved or the owner agreed to make necessary repairs.

The specific amendments to section 8 proposed to implement these modifications involve several steps. First, an amendment to section 8(b) of the United States Housing Act of 1937 is proposed to permit, under Annual Contributions Contracts (ACC's) executed after enactment of the Housing and Community Development Amendments of 1982, assistance contracts using the new payment standard for family-selected existing housing. It is anticipated that all new ACC's providing Section 8 Existing Housing subsidies after Fiscal Year 1982 will be under the modified program, except for "project-based" Existing Housing subsidies in connection with

Rent Supplement, Section 236 RAP and Section 23 Conversions.

Section 8(c) is proposed to be amended to retain most of the features of the current Section 8 program authority intact, but aspects of that authority formerly contained in section 8(d) have been merged into subsection (c) as well. Thus, subsection (c) would describe program elements which pertain to assistance contracts based upon a maximum monthly rent, while subsection (d), completely revised, would describe the new component of the Section 8 Existing Housing Assistance Program.

Proposed section 8(c)(5) (which has the same designation under current law) has been amended to clarify that the requirements of that paragraph apply only to newly constructed or substantially rehabilitated section 8 units. This was in fact the original intent of the provision, as made clear by the Conference Report on the Housing and Community Development Amendments of 1981.

Proposed new subsection (d)(1) requires the Secretary to establish payment standards (based on dwelling size and type) for different market areas, and states that these standards shall be used to determine the maximum monthly assistance which may be paid for any family. Payment standard levels shall be designed so as to assist families in securing decent, safe and sanitary housing, while providing assistance to the greatest possible number of families.

Payment standards (and fair market rents in section 8(c) as proposed to be revised) are required to be published in the Federal Register. However, the proposal would not make the determination of these amounts a "rulemaking." While the Department may well find it necessary to consult with the public concerning the appropriate level of FMR's and payment standards, these are essentially fact-based determinations which should be adjustable as appropriate to meet economic exigencies, rather than being subject to the delays occasioned by publication for comment.

Proposed revised section 8(d)(2) sets out the basic formula for determining the assistance to be made available for a family renting a unit under the modified program. The formula provides that the monthly assistance payment shall be the amount by which the (local) payment standard exceeds 30% of the family's monthly adjusted income. However, this formula is subject to a "minimum rent" exception. The assistance payment amount also may not exceed the amount by which the actual rental cost (rent to the owner plus allowances for utilities paid directly by the tenant, if any) exceeds the greater of 10% of family income or welfare rent. Thus, the minimum rent exception places a cap on the assistance payment and assures that a significant contribution toward the cost of the dwelling is made by the assisted family. Finally, the provision limits the maximum amount of the monthly assistance payment for any family to the amount by which the

payment standard exceeds 30% of the family's monthly adjusted income at the time it enters the program. This feature is intended to assure that available contract authority will be adequate to provide assistance to the family for the duration of the five-year ACC term. Families receiving assistance under the modified program will also be able to move to other areas--even other States--and retain their right to receive housing assistance under the program, but the amount of assistance available to a family making such a move would continue to be limited to the amount by which the payment standard exceeded 30% of the family's monthly adjusted income at the time the family first received assistance.

Proposed revised sec. 8(d)(3) provides that only families determined to be very low-income (i.e., at or below 50% of area median) may qualify for assistance under the modified program, unless the family had been previously receiving assistance under the United States Housing Act of 1937. Preference is required to be given to families which, at the time they are seeking assistance, occupy substandard housing, are involuntarily displaced, or are paying more than 50% of family income for rent. The first two of these preference criteria are already included in the United States Housing Act of 1937. The 50% of income for rent preference criterion is proposed for addition as a new statutory preference, in recognition of the fact that rent burden is a factor to be considered in determining those in need of

housing assistance. Administrative action to add the new preference category to the public housing and section 8(c) preference criteria is being undertaken by regulation.

However, proposed subsection (d)(4) would authorize the Secretary to override the normally applicable preference criteria in order to use annual contributions contract authority for special purposes. Thus, the Secretary under the modified program could use certificates for (1) families who previously were assisted under the public housing or present Section 8 program, (2) eligible families occupying units in formerly assisted projects acquired by the Secretary, or (3) families in units being rehabilitated under the proposed Rental Rehabilitation Program.

Subsection (d)(5) provides a rule applicable to so-called "vacancy payments" in the modified program. Payments for vacant units would be limited to the month during which the tenant leaves the unit.

Under subsection (d)(6), assistance payment contracts under the modified program would be limited to a term of five years or less. PHA's would be required to inspect a unit selected for occupancy by a family holding a certificate, to determine that the unit met housing quality standards set by HUD before any assistance payment could be made. Thereafter, the contract would require annual or more frequent housing quality standard inspections by the PHA during the contract term. If a dwelling

unit failed inspection, no assistance payment could be made unless the failure was promptly corrected and the PHA verified the correction.

Section 8(j) of the United States Housing Act of 1937, authorizing special terms and conditions for section 8 assistance to families renting manufactured homes and spaces or manufactured home spaces, is also revised to accommodate a certificate program for such units.

AMENDMENTS AFFECTING TENANT RENTS OR CONTRIBUTIONS

Section 203 proposes certain changes in the 1937 Act and in the gradual implementation provisions of the Omnibus Budget Reconciliation Act of 1981 occasioned by the proposed modified certificate program amendments contained in Section 202 of this bill. The requirement for annual review of family income has been moved from section 8(c)(3) to section 3(a) of the Act, to make the same annual recertification requirement applicable to both the present Section 8 authorities and the new modified Section 8 program.

The rent payment formula in section 3(a) of the Act is revised to provide that the 3(a) formula does not apply to "rents" paid by certificate holders under the modified Section 8 Existing Housing Program. (A similar, but not identical formula for determining assistance levels under the modified program is

set out separately in a proposed revised section 8(d)(2) of the 1937 Act.) Certificate holders under the modified program will pay "rent" at levels higher or lower than those provided for in 3(a), depending upon the price of housing selected by those families and the amount of subsidy produced by application of the payment standard formula.

Section 3(b) of the Act is proposed to be amended to clarify that the Secretary may establish income ceilings higher or lower than 50% of median on the basis of the Secretary's findings that such variations are necessary because of unusually high or low family incomes. The Secretary already has this adjustment authority for establishing income ceilings higher or lower than 80% of median, and comparable authority at 50% of median is appropriate, especially in light of the continued shift of emphasis toward assistance for very low-income families.

Section 322(i) of the Omnibus Budget Reconciliation Act of 1981 gives the Secretary discretion to provide for the gradual phase-in of the rent increases (from 25 to 30 percent of adjusted income) enacted last year for tenants receiving assistance when that Act was enacted. Rent increases resulting from this phase-in and from changes in Federal laws dealing with what benefits can be "counted" as income for housing assistance purposes are limited by this provision to 10 percent a year.

Subsection (c) of this section would amend section 322(i),

first, to provide also for the gradual phase-in of rent increases caused by the shift to a payment standard-based modified certificate program, second, to extend the gradual phase-in feature of the 1981 Act to tenants occupying assisted housing at or before the time regulations implementing the modified certificate program become effective, and third, to raise the annual percentage limit on rent increases from 10 percent to 20 percent.

The amendments would require the Secretary to assure that no family assisted at the time the modified certificate amendments are implemented would experience an increase in rent or contribution, as appropriate, greater than 20 percent in any 12-month period, if that increase were attributable to (1) percentage-of-income increases mandated by the Omnibus Budget Reconciliation Act of 1981; (2) modified certificate program amendments in this bill and (3) any other provision of Federal law redefining which governmental benefits are required or permitted to be considered as income. Any combination of these factors--which would otherwise cause a family's statutory contribution toward the cost of assisted housing to increase by more than 20 percent a year--would be limited to 20 percent per year, until the full effect of the (1981 and 1982) amendments is realized. In addition, the amendments would apply 1981 and 1982 gradual implementation provisions to the determination of a family's contribution under the new modified certificate program.

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Tenants who were not occupying assisted housing at the time the modified certificate amendments are implemented would be subject to immediate rent payment or contribution determinations in accordance with applicable law, with no "phase in". However, any such tenant who was occupying assisted housing at the time of a (future) change in Federal law redefining which governmental benefits are required to or may be considered as income would have the effect of such a change in law limited by a 20 percent increase cap.

INCREASED AUTHORITY FOR PAYMENTS FOR OPERATION OF LOWER INCOME HOUSING PROJECTS

Section 204 would amend section 9(c) of the United States Housing Act of 1937 to authorize appropriations for payments for operation of low-income housing projects of not to exceed $1,075,000,000 for the fiscal year beginning on October 1, 1982, and such sums as may be necessary for the fiscal year beginning on October 1, 1983.

The 1983 estimate reflects adjustments in operating subsidies based on proposed procedural and regulatory changes affecting tenant rent payments and PHA operations, more efficient PHA management, increased support anticipated to be provided by State and local governments and anticipated savings which are estimated to result from ongoing efforts to improve the energy efficiency of public housing projects. Included in the

adjustments in the impact of increasing the maximum allowable tenant rent contribution to 27 percent of income in 1983 for existing public housing tenants (to reflect the second-year increment of increasing the rent-income ratio to 30 percent of income by 1984) and charging 30 percent of income for all new public housing tenants. The administration also is proposing legislation to exclude food stamps in the calculation of tenant income and increase the maximum percentage that rents can be increased in any single year from [illegible] percent to [illegible] percent.

DEMOLITION OF [illegible] HOUSING

Section [illegible] would amend section [illegible] of the United States Housing Act of 1937 to alter the criteria for public housing demolition for uses other than the Comprehensive Improvement Assistance Program or under section [illegible] of the act dealing with the turn-over of public housing projects. HUD would approve applications for demolition of public housing where the project or any portion of it proposed for demolition is obsolete as to physical condition, location or other factors, making it unusable for housing purposes and no improvement program is feasible. Applications for partial demolition [illegible] in a program of modifications would be approved subject to a determination that the demolition would help to assure the useful life of the project.

The proposed amendment would also permit the approval of

assistance for demolition of unusable public housing projects without regard to the general application requirements pertaining to section 14(b) funding, in similar fashion as applications for funding of special purpose needs under section 14(i). The general application requirements, which relate to planning and management, have little relevance to applications exclusively for demolition of such housing. An application for such funding is more closely analogous to a recognized special purpose needs application, and should be handled in the same manner. Applications which include partial demolition incident to the rehabilitation of other remaining units would still be subject to the general application requirements for funding of applications under section 14(b).

The proposal would not continue section 14(f)'s requirement that PHA's undertake timely replacement of units demolished. This requirement could result, if continued, in costly operation of clearly obsolete projects or parts of projects solely because there are insufficient resources available to provide replacement units. Use of the section 6(f) criteria for funding eligibility would assure that demolition decisions are made on the basis of the condition of the project in question. At the time applications are approved, the Secretary would be required to determine that decent, safe, sanitary and affordable relocation housing was

available, as under the current section 14. In order to protect tenants displaced by demolition, HUD would be authorized to make available Modified Section 8 Housing Certificates for them. A total of 5,000 Modified Section 8 Existing Housing Certificates are budgeted in fiscal year 1983 for tenants of public housing units that are sold or demolished.

PURCHASE OF PHA OBLIGATIONS

Section 206 would repeal section 329E of the Omnibus Budget Reconciliation Act of 1981. That provision places an aggregate limit of $400 million on the amount of contracts HUD can enter into for payments to the Federal Financing Bank (FFB), after October 1, 1981, to cover the difference between tax-exempt rates of public housing obligations purchased by the Bank and the higher cost to the Bank of financing such purchases with funds it borrows at taxable rates. The authorized amounts would be adequate for the financing through the FFB of only $276 million in public housing authority obligations. In contrast, about $1.2 billion of new loan approvals will be made in each of fiscal years 1982 and 1983, which will require financing in the short-term tax-exempt market by FY 1985. In addition, $17.1 billion of short-term notes will be sold on the private market in 1982. This total includes the rollover of previous short-term financing, some of which may be rolled-over several times during the year.

This provision unduly restricts HUD's ability to continue use of the FFB as a financing mechanism for public housing obligations. The Bank offers a means of providing permanent financing for the obligations on a taxable, rather than a tax exempt, basis. The limit contained in the Reconciliation Act would force HUD to finance a large portion of public housing debt through either the costly and uncertain mechanism of short-term, tax-exempt notes or the sale of long-term, tax-exempt bonds on the private market. The Administration generally opposes use of tax-exempt financing because of the hidden and significant revenues foregone through use of this mechanism.

The repeal of section 329E would return HUD to the position of being able to rely on the authority of the Federal Financing Bank Act of 1973 for the use of the Bank for public housing financing. As in the past, the volume of financing would be controlled through HUD's appropriation Act.

OPERATING ASSISTANCE FOR TROUBLED MULTIFAMILY HOUSING PROJECTS

Section 207(a) would amend section 201 of the Housing and Community Development Amendments of 1978 to delete the Secretary's discretionary authority to provide operating subsidies under section 201 to troubled multifamily housing projects which, though HUD-assisted, are not covered by a mortgage which is insured or was formerly insured under the National Housing Act. Under existing section 201(c)(1)(A), projects which are assisted under the section 236 program of the National Housing Act or the rent supplement program

of the Housing and Urban Development Act of 1965 are eligible for assistance, even if not covered by a mortgage insured under the National Housing Act.

This proposal would restore the coverage of the "troubled projects" program to that originally proposed by the Department in 1978. It would permit scarce resources to be directed toward insured projects so as to prevent mortgage assignments and foreclosures and mitigate otherwise potentially excessive losses resulting from insurance claims, as well as to avoid substantial rent increases and physical deterioration in HUD-assisted projects for which the Department has a direct responsibility. Responsibility for further assistance to projects which are not insured by HUD should be borne by State and local government.

The amendment also would have the effect of limiting the requirements of section 202 of the Housing and Community Development Amendments of 1978 to HUD-insured projects. Section 202 requires the Secretary to assure, among other things, that tenants of projects eligible for troubled projects funding have a chance to participate in certain project management decisions and are permitted to organize tenant associations to represent tenant interests.

Extension of these requirements to State-aided, uninsured projects appears to have been unintentional. The Senate provision from which section 202 was drawn applied only to HUD-insured projects. The conference report indicates that the Senate provision was adopted,

with an amendment to "conform" its coverage to that of the troubled projects program. Research has indicated no conscious intent to apply section 202's provisions to State-aided projects. The Department believes that the proposed change is appropriate, since the relationship between the responsible State agencies and tenants of State-aided projects should be a matter for these parties to work through without Federal intervention.

Section 207(b) would amend section 236(f)(3) of the National Housing Act to extend through September 30, 1984 the period during which amounts in the section 236 rental housing assistance fund may be approved in appropriation Acts for use in the Troubled Projects Program. Existing law subjects the making of payments from the fund to approval in an appropriation Act, and prohibits any amount from being so approved for any fiscal year beginning after September 30, 1982.

This proposed amendment is necessary to permit amounts in the rental housing assistance fund to be used for the Troubled Projects Program during fiscal years 1983 and 1984. The Department intends to request approval, in the HUD appropriation Act for fiscal year 1983, to use the $24 million expected to be received in the rental housing assistance fund during that year.

HOUSING FOR THE ELDERLY AND HANDICAPPED

Section 208 would amend section 202(d)(2)(B) of the Housing Act

of 1959 to delete the requirement (added in 1978) that non-profit entities receiving loans for developing housing for the elderly and handicapped must include, on their governing boards, members selected in a manner to assure significant representation of the views of the community in which the project is located.

A significant number of national organizations which are active sponsors of Section 202 housing have objected strenuously to this requirement. The sponsors have pointed out that, as national organizations, it is impossible for them to have representatives on their governing boards from all communities in which they may wish to operate. Similar concerns have been expressed by State-wide housing corporations, as well as county and community groups, which find it difficult to have representatives from all areas in which they intend to operate. The existing requirement of section 202 curtails participation by many organizations which have been organized specifically to share resources and to develop a more comprehensive and coordinated approach to providing housing for the elderly or handicapped. Moreover, with the exception of one or two isolated cases, there is no evidence of the need for this provision.

TITLE III -- PROGRAM AMENDMENTS AND EXTENSIONS

EXTENSION OF FEDERAL HOUSING ADMINISTRATION MORTGAGE INSURANCE PROGRAMS

Section 301 of the bill would extend for two years (through September 30, 1984) the authority of the Secretary of Housing and Urban Development to insure mortgages or loans under certain HUD-FHA mortgage or loan insurance programs contained in the National Housing Act. A one-year extension is proposed for the section 235 program of homeownership for lower income families.

Under existing law, the authority of the Secretary of Housing and Urban Development to insure mortgages and loans under these programs will expire on September 30, 1982. After that date, the Secretary may not insure mortgages or loans under any of the major HUD-FHA insuring authorities contained in the National Housing Act, except pursuant to a commitment to insure issued before that date.

Insuring authorities which will expire on September 30, 1982 and are proposed for two-year extension include those for the following HUD-FHA mortgage or loan insurance programs: title I - property improvement and manufactured home loan insurance; section 203 - basic home mortgage insurance; section 207 - rental housing insurance; section 213 - cooperative housing insurance; section 220 - rehabilitation and neighborhood conservation

housing insurance; section 221 - housing for moderate-income and displaced families; section 222 - mortgage insurance for servicemen; section 223 - miscellaneous housing insurance, including insurance in older, declining urban areas and for existing multifamily housing projects and hospitals; section 231 - housing for the elderly; section 233 - experimental housing; section 234 - condominiums; section 237 - special mortgagors; section 240 - homeowner purchases of fee simple title; section 241 - supplemental loans for multifamily housing projects, health facilities and energy conserving improvements; section 243 - homeownership for middle-income families; section 244 - mortgage insurance on a co-insurance basis; section 245 - mortgage insurance on graduated payment mortgages; and title X - land development. The text of the extension for section 245 appears in the proposed rewrite of that provision in section 316 of this bill.

The proposed extensions of the above-listed mortgage insuring authorities are designed to guarantee the continued availability of FHA mortgage insurance and thus to maintain and enhance the Department's capacity to contribute to achievement of the national housing goal of "a decent home and a suitable living environment for every American family."

Last year, an extension of [illegible] was requested for section 235 of the National Housing Act, in order to [illegible] units in the pipeline [illegible]

the Housing and Community Development Amendments of 1981 and in the International Banking Facility Deposit Insurance Act (Public Law 97-110, approved December 26, 1981) provided special instructions regarding the Secretary's authority to enter into new contracts for assistance payments in connection with section 235 mortgages.

First, the Secretary may not enter into new assistance payments contracts after March 31, 1982, except pursuant to a _firm_ commitment (i.e., an _insurance_ commitment) issued on or before that date.

However, an exception to the March 31, 1982 firm commitment cutoff date is provided for "other" commitments which were "issued by the Secretary prior to June 30, 1981, reserving funds for housing to be assisted under [section 235] where such housing is included in [an Urban Development Action Grant project]."

Finally, Public Law 97-110 provided still another exception to the March 31 firm commitment cutoff date for "other" commitments which meet all the following criteria:

-- issued on or before September 30, 1981;

-- involve section 235 housing to be developed on land which was municipally owned on that date; and

-- involve a local government contributing at least

$1000 per unit from CDBG funds and $2000 per unit of additional funds to assist the section 235 housing.

Section 235(h)(1), which governs section 235 assistance payments, goes on to provide that "in no event may the Secretary enter into any new contract for assistance payments...after September 30, 1983."

It is unclear that all categories of persons seeking assistance payments contracts described in section 235(h)(1) of the Act will have adequate opportunity to secure firm commitments for insurance before September 30, 1982 -- the current law's expiration date for insurance under section 235(m). Since section 235(m) only authorizes insurance after September 30, 1982 pursuant to commitments to insure made before that date, some of the persons sought to be assisted by the above-discussed section 235(h) "saving" provisions might be unable to secure an insured mortgage unless the insuring authority is extended. The proposed amendment would provide, however, for unconditional termination of section 235 insuring authority after September 30, 1983.

Extensions have not been included for the following provisions of the National Housing Act: section 235(q) (counter-cyclical economic stimulus), section 236 (rental and cooperative housing for lower income families), section 232 (nursing homes), section 242 (hospitals), title VIII (armed forces-related

housing) and title XI (group practice facilities).

The section 235(q) authority (countercyclical economic stimulus), scheduled to expire on September 30, 1982, is not proposed for extension. This emergency authority has never been activated.

Section 236 was also extended for one year by the Housing and Community Development Amendments of 1981 to permit projects in the pipeline to be processed. Most such projects have now been processed or cancelled, and those still in the pipeline have secured commitments which will make possible the provision of insurance after September 30, 1982 pursuant to a commitment to insure made before that date. Thus, there is no necessity to extend the insuring authority.

An extension of the authority to provide insurance for nursing homes and intermediate care facilities under section 232 is not being sought beyond the present September 30, 1982 expiration date. Nursing homes and intermediate care facilities are eligible for Medicare and Medicaid reimbursement. Many such facilities currently in existence have been developed and financed without the benefit of federally insured mortgages. Section 232 has not been a high-volume mortgage insurance program, and there appears to be no reason to believe that the private market cannot meet the financing needs of such facilities in the absence of the section 232 program.

The Section 242 hospital insurance program similarly would appear to require no extension. The Administration's attempts to bring cost containment to the health and medical sector, plus the fact that many areas are already over-bedded due to excess hospital facilities, suggest that only a very limited need exists for financing hospitals. Since the private market has provided financing to many of the hospitals currently in existence, and appears quite capable of meeting credit needs in those few cases where new hospital construction is appropriate, extension of section 242 is not being sought beyond the current expiration date of September 30, 1982.

The authority to insure armed forces housing under title VIII of the National Housing Act (sections 809-810) is not proposed for extension beyond the current September 30, 1982 expiration date. These programs have been inactive for several years; no insurance was written under their authority during fiscal year 1981, and no applications for insurance are currently pending.

Finally, there has been little activity under the Title XI authority to insure Group Practice Facilities, suggesting that whatever need exists is being met adequately by the private market. Accordingly, no further extension of this authority is being sought.

Under all four of these programs--section 232, 242, Title

VIII and Title XI -- commitments to insure entered into before the scheduled September 30, 1982 expiration date will be honored after that date.

FEDERAL HOUSING ADMINISTRATION

GENERAL INSURANCE FUND

Section 302 would amend section 519(f) of the National Housing Act to authorize the appropriation of such sums as may be necessary to cover losses of the General Insurance Fund. Existing law contains an overall ceiling on the amounts which may be appropriated for this purpose.

Losses sustained as a result of the sale of acquired property are not a function of the amount authorized for appropriations to restore the losses. The losses represent the difference between the purchase price of units acquired through the Department's insurance activities, expenses incurred through maintenance and repair and the proceeds realized from sale of these properties. The authorization does not limit the loss but merely places a limitation on the amount which may be sought in recompense for losses already sustained. The present authorization limitation requires the Department to seek an increase in the amount authorized for appropriation before an appropriation to restore the losses can be enacted. The proposal would simplify this process by authorizing the appropriation of the sums necessary for this purpose.

RESEARCH AUTHORIZATIONS

Section 303 would authorize the appropriation of $20 million in fiscal year 1983 and necessary sums for fiscal year 1984 for the Department's Research and Technology Program. Particular areas of study in fiscal year 1983 will include:

— strategies for increasing the efficiency and effectiveness of assisted-housing programs through reforms of existing programs and evaluation of alternative programs;

— analysis of (1) the relationship between tax policies and housing, (2) alternative housing finance mechanisms (such as alternative mortgage instruments), (3) financial institution regulation and reform, and (4) alternative tax and other financial incentives for housing;

— ways to reduce the component costs of housing (costs of development, building, financing, and operating);

— development and dissemination of better methods for community management and delivery of local government services;

— identification of successful neighborhood strategies;

— analyses of new or improved alternatives for urban economic development, including an examination of enterprise zones, the role of small businesses, regulatory and tax relief,

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public finance and tax policy, changes in capital investment by cities, the impact of Federal tax and grant policies on central cities, and the formulation of a viable and realistic urban policy; and

-- issues related to fair and nondiscriminatory housing.

ELIMINATION OF REQUIREMENTS THAT FHA INTEREST RATES BE SET BY LAW

Section 304 would amend the insuring authorities in the National Housing Act which are proposed for extension beyond fiscal year 1982 (except section 235) to allow an insured mortgage or loan to bear interest at a rate agreed upon by the borrower and the lender. These authorities are: title I - property improvement and manufactured home loan insurance; section 203 - basic home mortgage insurance; section 207 - rental housing insurance; section 213 - cooperative housing insurance; section 220 - rehabilitation and neighborhood conservation housing insurance; section 221 - housing for moderate-income and displaced families; section 231 - housing for the elderly; section 234 - condominiums; section 240 - homeowner purchases of fee simple title; section 241 - supplemental loans for multifamily housing projects, health facilities and energy conserving improvements; and title X - land development.

The proposal would repeal section 3 of P.L. 90-301 -- HUD's interim authority to establish maximum FHA interest rates -- as well as section 4 of that Act, which established a commission on interest rates which expired in 1969.

The amendment to section 235 would provide for continuation of the Secretary's authority to set interest ceilings, essentially in the same manner as is authorized under present law in Public Law 90-301. This reservation of authority for purposes of section 235 mortgages is necessary to close out, during fiscal 1983, the section 235 homeownership program for lower income families. Since the section 235 subsidy is the difference between the actual interest rate on the mortgage and a below market rate set by HUD, to allow negotiated interest rates in this program might prove prohibitively expensive. Since the authority to insure under section 235 is proposed for expiration on September 30, 1983, the need for a continuation of Secretary-established interest ceilings is only temporary.

The administered ceiling on the FHA contract interest rate has outlived its usefulness. The ceiling is an outdated manifestation of concern that some lenders would take advantage of buyer ignorance and charge an "above market" rate of interest. Mortgage rates were relatively stable in the post-WW II years by today's standards, but differed among various regions of the country. This difference reflected the relatively greater demand

for funds in some areas and the immobility of mortgage funds across regions. In the interest of promoting a truly national mortgage market and facilitating the flow of funds between regions, FHA attempted to set a national mortgage rate.

Over the years the perception has developed that, by setting a ceiling, FHA determines mortgage interest rates. This is simply not the case. FHA mortgages are sold to investors at market yields. Investors discount the loans to bring the yield up to those available on alternative investments. These discount "points" can be ultimately passed on to borrowers, typically in the price charged by the seller.

Mortgage markets are now national in scope and extremely competitive. Homebuyers can readily obtain information on the going rate for a mortgage loan, and can negotiate for themselves a market interest rate. Thus, the ceiling is no longer needed.

The recent volatility in interest rates has made the ceiling extremely difficult to administer. The FHA ceiling must reflect current market interest rates if homebuyers are to obtain mortgage credit. When interest rates move by as much as five discount points within a week, as they have recently, it becomes increasingly difficult to administer the contract interest rate effectively.

In summary, the FHA will follow the conventional mortgage market by letting the borrower and lender determine the mortgage interest rate.

TREATMENT OF FHA SINGLE FAMILY MORTGAGE INSURANCE PREMIUMS

Section 305 would amend the single family insuring authorities of the National Housing Act to exclude the amount of the mortgage insurance premiums paid at the time the mortgage is insured from the applicable maximum mortgage and down payment requirements. These changes are intended to complement the Department's proposed revision to the single family insurance premium collection structure. Under this plan, the Department will, by regulation, require the purchaser to pay at the time of settlement the total expected amount of premium due, based upon the average expected term of the loan. The premium will be calculated on a discounted present value basis and will be considered as an eligible expense, included within the amount of the approved loan.

This new procedure will result in significant reductions to the workload of the Department, and also will free loan servicers from the monthly remittance requirement on new loans. The change is expected to have only a small impact on the home purchaser's monthly payment requirement, while increasing premium receipts early in mortgage life.

Under current law, however, the amount of the mortgage insurance premium payable at settlement is included in the amount of the principal obligation of the loan against which the statutory maxima are applied. If the higher amounts contemplated by the new procedure were similarly included, there would be a corresponding decrease in the insurable mortgage amount attributable to the dwelling being purchased. The proposed amendments would prevent this result by excluding the amount of the premium from the maximum mortgage determinations. Similarly, since insurance premiums are presently included in determining down payment amounts, the amendments would exclude them from down payment determinations. The amendments would, however, not reduce the amount of insurance protection which is afforded the lender.

NON-OCCUPANT SINGLE FAMILY MORTGAGORS

Section 306 would provide higher maximum mortgage amounts for non-owner-occupant, one- to four-unit dwellings insured under section 203(b) of the National Housing Act.

Present law limits the principal amount of an owner-occupant mortgage which may be insured under section 203(b) to the lesser of specified dollar amounts or loan-to-value ratios. Thus, the maximum insurable amount for a typical single family home is the lesser of $67,500 or the sum of 97 percent of the first $25,000 of value and 95 percent of the remainder. Section 203(b)(8) of the Act limits the

maximum insurable amount for investor-owners to 85 percent of the owner-occupant ceiling. Thus, for a typical single family home, the limit is 85 percent of $67,500, or $57,375.

This amendment would set the investor limit at the lesser of the otherwise applicable dollar amount or 85 percent of the otherwise applicable loan-to-value ratio for owner-occupant units. This would make the maximum dollar amount which may be insured for investors the same as that for owner-occupants, while at the same time retaining existing restrictions on the percent of value which could be insured for investor-owners. The proposed change would help stimulate investor interest in one- to four-unit dwellings, thereby resulting in increased rental housing supply.

PREMIUM CHARGES FOR INSURANCE OF ALTERNATIVE MORTGAGE INSTRUMENTS

Section 307 would authorize the Secretary to increase, if necessary, premium charges for insurance of mortgages involving alternative financing mechanisms such as graduated payments, adjustable interest rates, shared appreciation, or growing equity.

Section 203(c) of the National Housing Act authorizes the Secretary to vary premium charges for the insurance of mortgages under the separate sections of title II of the National Housing Act, but premium charges <u>among</u> mortgages insured under a particular section of the Act must be uniform. The alternative

mortgage plans proposed to be authorized pursuant to revised section 245 and proposed new sections 247, 248 and 249, (and other alternative mortgage instruments which may be developed under existing authority) may require additional premium charges to make the provision of insurance actuarially sound. Alternative financing mechanisms are intended to be used in conjunction with existing basic mortgage insurance statutes contained in title II. Thus, for example, a single family home with an adjustable rate mortgage might be insured "under" section 203(b), "pursuant to" section 247. This amendment would make clear that, when alternative financing is used in conjunction with a particular section of title II authorizing insurance, the Secretary may provide for premium charges which are not the same as those which would be applicable to a level payment mortgage insured under the same section, and that premium charges applicable to such alternative mortgage instruments may exceed 1 percent per year where necessary.

MODIFICATION OF FHA DEBENTURE TERMS

Section 308 would eliminate the statutory requirement that any debentures issued by the FHA in payment of insurance claims be redeemable at par. Mortgagees frequently use these debentures for payment of insurance premiums under the various insurance programs. Permitting lenders the option of redeeming debentures at par in exchange for premiums has had a serious impact on the

actuarial calculations involved in writing mortgage insurance in a manner consistent with sound financial management. Debentures submitted for redemption usually are worth substantially less than par. This is because the interest rate on these debentures is tied, at the time of origination, to the prevailing rate on outstanding long-term Treasury obligations, and that rate does not necessarily reflect the prevailing market rate at the time of redemption. The debentures so used, therefore, can result in a significant loss of FHA insurance fund revenues.

DISCRETIONARY AUTHORITY TO REGULATE RENTS AND CHARGES

Section 309(a) would remove language in section 207 of the National Housing Act mandating that the Secretary regulate project rents and rates of return, and would substitute discretionary authority in the Secretary to provide for such regulation. This change (and the parallel amendment of section 234(d)(2) contained in subsection (b)) would conform these authorities to other National Housing Act multifamily authorities (sections 220(d)(2)(A), 221(d)(4), and 231) which provide for discretionary authority to regulate rents and charges.

The purpose of these changes is to permit the Department to deregulate rent levels in unsubsidized insured projects. Deregulation is expected to help assure the financial stability of insured projects, and will reduce administrative costs for the

Department by eliminating the review and processing of applications for rent increases.

It should be noted that such deregulation would have applicability, not only to future unsubsidized project mortgages, but to existing mortgages as well. After appropriate regulatory changes were promulgated pursuant to these amendments, existing mortgagors would be invited to amend their regulatory agreements to remove requirements for HUD approval of rent increases. The Department would, however, reserve the right to resume regulation of rents and charges for any such project in the future.

MORTGAGE INSURANCE FOR MANUFACTURED HOME PARKS FOR THE ELDERLY

Section 310 would amend section 207(b)(2) to permit the insurance of manufactured home parks designed exclusively for occupancy by the elderly. Present law states that the insurance of section 207 mortgages is intended to facilitate particularly the production of rental accommodations "suitable for family living." Section 207(b)(2) goes on to prohibit the provision of insurance under section 207 unless the mortgagor certifies under oath that there will be no discrimination "by reason of the fact that there are children in the family...."

The proposed amendment would retain this basic rule, but would provide language clarifying that exception may be made with regard to manufactured home parks designed exclusively for the

elderly. Recent surveys indicate that about one-third of all manufactured home units are occupied by elderly persons. Since section 207 is the only authority for insuring manufactured home parks, the change in section 207(b)(2) proposed in this section of the bill is necessary to meet the need for insurance to develop parks designed, constructed and managed for occupancy exclusively by the elderly.

INCREASED MORTGAGE LIMITS FOR SUBSTANTIAL REHABILITATION

Section 311 would amend the mortgage limit provisions of Sections 220, 221(d)(3) and 221(d)(4) of the National Housing Act to facilitate refinancing to perform substantial rehabilitation. Currently under these provisions, the limits on mortgages for substantial rehabilitation of properties are 90 percent of the sum of the cost of repair plus the value of the property before rehabilitation. However, where there is an existing mortgage, and application to insure a new mortgage under one of these provisions is made, the mortgage limits would be 90 percent of the sum of the estimated cost of repair plus the existing indebtedness (rather than the value of the property before repair). The amendment would delete the latter formula, so that the mortgage limits would be the same for refinancing as it is for new financing for substantial rehabilitation.

The limitation involving existing indebtedness for refinancing in the current laws prevents owners from realizing any of their equity if they wish to rehabilitate a project and retain ownership. This forces sales of the properties if the owners are to realize any equity from the projects. This limitation is contrary to a policy of encouraging rehabilitation and retention of rental property by present owners. As a result of this inequity, many projects requiring rehabilitation cannot receive the benefits of rehabilitation without the sale to another owner.

ASSIGNMENT OF SECTION 221(g)(4) MORTGAGES TO THE GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

Section 221(g)(4) permits mortgagees holding section 221 mortgages which are not in default to assign them -- twenty years from the date of insurance endorsement -- to the Secretary, and to receive the benefits of insurance.

The purpose of this amendment is to authorize the Secretary to direct mortgagees exercising this assignment option to deliver the mortgage and credit instruments directly to the Government National Mortgage Association. Upon such an assignment to GNMA, the rights of the mortgagee would be identical to those provided in the present law. The amendment proposal would, however, establish a more effective process within HUD for dealing with these assignments. GNMA, acting as agent for the Secretary,

would take delivery of the mortgages and would pay for them with debentures issued pursuant to the current procedure outlined in section 221(g)(4). These debentures would be debited against the FHA fund. Upon sale of the loans, GNMA would provide the proceeds to FHA. GNMA would be reimbursed for all administrative costs.

Without this amendment, FHA could continue to be responsible for taking assignment and servicing these mortgages, but an increase in staffing in HUD's Office of Finance and Accounting would be required, since that office is not prepared to take on the additional responsibility caused by the forthcoming eligibility of numerous section 221 mortgages for 20-year assignment.

Explicit statutory authority to instruct mortgagees to transfer these mortgages directly to GNMA would eliminate the paperwork and time delays within HUD involved in requiring receipt of the mortgages by the Office of Finance and Accounting, and subsequent transfer to GNMA for purposes of handling debenture issuance and subsequent sale of the mortgages.

GNMA has the greater experience in handling such sales, and will also be in a position to "space" its sales, so that HUD mortgages will not be sold in competition with GNMA's own mortgage sales.

TERMINATION OF SECTION 221 BUY-BACK PROVISION

Section 313 would amend section 221(g)(4) of the National Housing Act to eliminate the "buy-back" feature of that provision with respect to commitments to insure under section 221 entered into after the effective date of the Housing and Community Development Amendments of 1982. Section 221(g)(4) now permits mortgagees to assign to HUD current mortgages which are in their 20th year of amortization. HUD exchanges the mortgages for debentures at the going rate for the face value of the outstanding debt. The proposal would only affect those mortgages for which commitments to insure were made after the effective date of the provision.

Because of the current high interest rates, it has become more and more advantageous for mortgagees to assign mortgages to HUD and take debentures at the "going rate" of interest. This proposal would avoid expected future losses to the FHA insurance funds based on business transacted after the provision's effective date.

MORTGAGE INSURANCE FOR CONDOMINIUMS

Section 314 would amend section 234(c) of the National Housing Act to allow insurance of any condominium unit in a project that has been approved by the Secretary. The proposal expands HUD's authority to permit insuring individual condominium units in a project by eliminating the conditions to such insurance contained in existing law. Under current law, HUD may insure individual condominium units

if one of the following conditions is met: (1) the project is or has been FHA-insured or VA-approved; (2) there are less than 12 units in the building; or (3) if the building has 12 or more units, it is more than a year old.

Elimination of these conditions would lessen the constraints on insured financing for condominium units and would result in expanded homeownership opportunities. Additionally, the proposal would simplify the insuring process and eliminate the amount and degree of FHA review and regulation.

This proposal would also bring HUD into line with what the Veterans Administration has been doing for several years. Since 1974, the VA has allowed insurance for any condominium unit. The enactment of identical FHA and VA condominium insuring authorities would facilitate implementation of section 905 of the Housing and Community Development Amendments of 1978, which as part of the paperwork reduction program, suggested that HUD, VA, and FmHA develop uniform application and other requirements for single family and multifamily programs.

REMOVAL OF RESTRICTION ON FHA CO-INSURANCE

Section 315 would strike the second and third sentences of section 244(d) of the National Housing Act. These provisions limit the amount of mortgages and loans which may be insured on a coinsured basis by the FHA to 20 percent of the aggregate

principal amount of all mortgages and loans insured under Title II of the Act. The 20 percent limitation also applies separately to multifamily and single family mortgages.

With respect to multifamily mortgages, HUD anticipates fewer insurance applications in both FY 1982 and FY 1983, as well as a drop in the overall amount of multifamily mortgage insurance written. This will occur at a time when HUD has developed regulations for coinsurance for purchase or refinancing of multifamily properties (under section 223(f)) and for private lender financing of new construction or substantial rehabilitation (under section 221). State Housing Finance Agencies already may coinsure and perform delegated processing under section 221, which accounts for approximately two-thirds of FHA's multifamily business. The coincidence of diminishing overall multifamily insurance activity and increased policy and program emphasis upon coinsurance makes the existing 20 percent limitation of section 244(d) a severe inhibiting factor in carrying out FHA multifamily operations. Removal of the restriction will permit a more extensive and more effective FHA multifamily insurance program than would otherwise be possible.

With respect to single family insurance, HUD estimates that both applications and the amount of insurance written will increase in FY 1982 and FY 1983. In FY 1981, coinsurance written represented about 1.25 percent ($156 million) of single family

insurance written ($12.5 billion). Although single family operations may continue to work within the 20 percent limit for the present, as in multifamily operations, HUD will be making improvements in its coinsurance regulations with a view toward making the coinsurance approach more attractive to lenders. HUD anticipates a substantial increase in coinsurance activity as a consequence.

The benefits of coinsurance are clear and compelling: it maximizes the role of the private sector, it reduces processing time through delegated processing, and it limits HUD's exposure to losses through risk sharing. By removing the current 20 percent restriction, increased cooperation and direct involvement of the private sector in FHA insurance programs will be possible.

ALTERNATIVE MORTGAGE INSTRUMENTS

Section 316 would expand the Secretary's authority to insure mortgages using alternative mortgage instruments. Subsection (a) would amend section 245 of the National Housing Act to consolidate the separate authorities now contained in section 245(a) and (b) into a single graduated payment mortgage (GPM) authority for one- to four-family dwellings in accordance with the more generous limitations now contained in section 245(b), and to eliminate certain restrictive features of the present section 245(b) GPM program. In addition, amendments are

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proposed in revised subsection (c) to make possible the use of GPM's for multifamily projects.

The proposed revisions to section 245(b) would delete the threshold requirement that a mortgagor be unable reasonably to afford to finance a purchase by means of any other mortgage insurance program. This change would make any otherwise qualified mortgagor eligible for an insured graduated payment mortgage.

Second, the requirement limiting section 245(b) insurance to mortgagors who have not owned dwelling units within the preceding three years would be stricken.

Finally, restrictions on the number of mortgages or the aggregate amount of initial principal obligation of mortgages insured under section 245 are also proposed to be removed.

Section 245(c) as proposed to be amended would provide authority for GPM's for multifamily insured projects. A major deterrent to the production of multifamily housing is the high cost of financing. Availability of GPM's would assure lower principal and interest payments on the mortgage in the early years of a project. Later, as debt service payments increased, reasonable rental increases would cover these costs. Use of the GPM approach in the multifamily context would assist the badly

sagging rental housing market without the help of Federal subsidies.

GPM's for multifamily projects would not, however, have requirements identical to those applicable to single family insuring authorities. The initial principal obligation of a multifamily mortgage would not be permitted to exceed the percentage of value or replacement cost required by the particular title II insuring authority with which the GPM authorization was linked. During the term of the mortgage, the principal obligation (including interest deferred and added to principal) would not be permitted to exceed the property's projected value at any time.

Projected value of a multifamily project would be determined in the same manner as under current section 245 for single family dwellings--by means of a HUD calculation based on the initial value of the property, projecting increased value at a rate not to exceed 2 1/2% per year.

Subsection (b) would provide authority for HUD to insure single-family Adjustable Rate Mortgages (ARM's) on a limited basis. Under the authority, insurance activity would be limited to 125,000 mortgages in any fiscal year. Interest rate adjustments would be indexed to a national interest rate index which the Secretary of HUD would specifically approve in regulations.

These FHA-insured adjustable rate mortgages would include safeguards for the consumer. To protect participating homeowners, statutory limits would control the size and frequency of interest rate adjustments. A limit of one adjustment per year, with maximum increases in the interest rate of 1 point a year and 5 points over the life of the mortgage, would be established. The mortgagee would be required to provide information to the mortgagor describing particular features of the variable rate mortgage, including a hypothetical "worst case" payment schedule.

At present, HUD cannot insure a mortgage financed with a variable interest rate. If inflation rates and interest rates remain high, the ARM is likely to become a primary mortgage instrument available to a purchaser in the conventional market. In that event, it would be desirable for FHA to be able to offer a choice between ARM's and fixed-rate mortgages.

Section 316(b) proposes a new section 248 of the National Housing Act which would provide authority for HUD to insure Shared Appreciation Mortgages (SAM's) for single-family housing. Insurance activity would be limited to 50,000 mortgages in any fiscal year.

Because of current economic conditions, including high and volatile interest rates, alternative mortgage instruments such as the SAM should be insurable by FHA in order to supplement the

standard, fixed-rate mortgage, and to provide homebuyers with an alternative to the Department's Graduated Payment Mortgage (GPM) program and the proposed Adjustable Rate Mortgage (ARM). SAM's make possible substantial reductions in down payments, early year monthly mortgage payments or both, in return for a percentage share of any appreciation accruing to the property. The SAM is particularly well suited to prospective secondary market purchasers; to the extent effective yields are keyed to property appreciation, such mortgages in most cases will provide a direct hedge against inflation.

Under the proposal, a lender's share of the appreciated value of the property would be due and payable at the time the insured property is sold or transferred, or, in the event there is no such sale or transfer, upon payment of the mortgage.

By regulation, safeguards for buyers and owners would include maximum sharing provisions and full disclosure of the terms and conditions of the mortgage contract.

In the event of a default, the mortgagee would have a right to make an insurance claim, but insurance benefits would not include the mortgagee's share of net appreciated value.

This proposal reflects HUD's intent to serve first-time homebuyers, and to generally upgrade the Department's insuring

authority to be responsive to current needs and effective in the current mortgage market.

Section 316(b) would also provide authority for HUD to insure Shared Appreciation Mortgages (SAM's) for multifamily housing. In addition, subsections (c) through (f) would amend sections 207(c)(3), 220(d)(4), 221(d)(6), and 231(c)(5), respectively, to allow HUD discretion to insure loans which do not completely amortize over the loan term.

Current economic conditions have made the production of multifamily rental housing difficult. A particular problem facing the multifamily housing industry is the reluctance of lenders to invest in fixed-rate mortgages of 30 or 40 years duration. Alternatives to traditional long-term mortgage instruments need to be insurable by HUD in order to stimulate unsubsidized rental construction.

The multifamily SAM will allow HUD to insure loans of 15 years or longer which have level payment amortization schedules which would completely amortize in 30 years or less. Mortgagors would be allowed to take advantage of the generally lower interest rates available for shorter term financing.

Under the proposal, a lender's share of the appreciated value would be due and payable at the time the insured property is sold or transferred or at the expiration of the loan term.

Used either in tandem or separately, the multifamily SAM proposal and the proposed discretion in the Secretary to insure mortgages which do not provide for complete amortization will substantially lower the monthly mortgage payments on multifamily loans and thereby encourage the production of rental housing.

STRUCTURAL DEFECTS IN INSURED PROPERTY

Section 518(a) of the National Housing Act authorizes the Secretary to make expenditures to correct or compensate for structural defects in single family homes which were approved for FHA insurance prior to construction. Section 317 would amend section 518(a) to specify that the Secretary may also correct or compensate for structural defects in FHA-insured new homes which were approved for loan guaranty by the Veterans Administration prior to construction.

Section 213 of the National Housing Act states that VA loan guaranty, insurance or direct loan approval prior to the beginning of construction may be substituted for the Secretary's approval. The proposal would clarify that VA approval is the equivalent of the Secretary's for purposes of correcting or compensating for structural defects.

TIME OF PAYMENT OF PREMIUM CHARGES

Section 318 would amend section 530 of the National Housing Act to clarify that the Department's obligation to collect

mortgage insurance premiums on a monthly basis, and to charge interest for late payment of monthly premiums, applies only to the Department's single family programs. The amendment would permit continuation of the existing practice of collecting premium payments from multifamily mortgagees on an annual basis, with interest payable only in the case of late remittance of the annual payment.

In the past, HUD has not required monthly collection of premiums for its multifamily mortgages. Premiums for those programs are paid by the mortgagor in advance and are escrowed by the mortgagee. Collection of these premium payments on a monthly basis would increase paperwork and would be staff-intensive. It would also unnecessarily disrupt existing finance and accounting operations, which are geared to annual receipt of such payments.

As amended, section 530 would continue to require that premiums be paid "promptly upon their receipt from the borrower" in the case of the single family programs, but would require, for all other insuring authorities, that premiums be paid "promptly when due to the Secretary" (i.e., annually). Interest payable to the Secretary would continue to be required for late payment of premiums, but such interest would accrue beginning twenty days after the mortgagee's receipt of premium payments from the borrower in the case of single-family mortgages, while in the multifamily programs, interest would be due for the period

beginning twenty days after the premium payment's due date.

SINGLE FAMILY MORTGAGE INSURANCE ON INDIAN RESERVATIONS

Section 319 would add a new section to title V of the National Housing Act authorizing the Secretary to insure a mortgage covering a one- to four-family dwelling executed by a member of an Indian tribe covering property located on an Indian reservation without regard to limitations in the NHA, such as those regarding marketability of title, or any other statutory restriction which impedes the availability of mortgage insurance on Indian lands. The insured dwelling would have to be a principal residence.

The unique nature of the ownership of land on Indian reservations and laws governing the disposition of Indian land makes lenders unwilling to provide mortgage financing for housing on reservations. HUD cannot induce lenders to make mortgage loans by providing insurance because the National Housing Act has requirements for insurability relating to marketability of title that cannot be met by Indian reservation land. The proposal would enable the Secretary to make mortgage insurance available without regard to such statutory restrictions. Mortgages insured under this section would be obligations of the General Insurance Fund.

PROPERTY DISPOSITION AND RELATED AMENDMENTS

Section 203 of the Housing and Community Development Amendments of 1978 established policies and procedures for the management and preservation of HUD-owned multifamily housing projects. The statute directs HUD to manage and dispose of these projects in a manner that would protect the financial interests of the Federal Government and be less costly to the Federal Government than other reasonable alternatives by which the Secretary could strengthen the goals of (1) preserving housing units for use by low- and moderate-income families; (2) preserving and revitalizing residential neighborhoods; (3) maintaining the existing housing stock in a decent, safe and sanitary condition; (4) minimizing involuntary tenant displacement; (5) minimizing demolition; and (6) maintaining the project for the purpose of providing rental or cooperative housing. The statute also requires the Secretery to assure displaced tenants in covered projects the right to return to a repaired unit, to occupy another HUD-owned unit, to obtain assistance under the United States Housing Act of 1937 or receive any other appropriate relocation assistance.

Section 320 would amend section 203 to remove most of these restrictions on the management and disposition of HUD-owned property. The proposal would retain the requirement of 203(d)(1) of the Act that, whenever tenants of any

HUD-owned multifamily rental project are to be displaced, the Secretary shall inform them of their pending displacement and of any available relocation assistance. More importantly the proposal would authorize the Secretary to provide assistance under the new Modified Section 8 Existing Certificate Program to any very low-income tenant (50 percent of area median income or below) in HUD-owned projects assisted under the section 236, 221(d)(3), rent supplement or section 202 (other than section 8-assisted) programs. (Section 8-assisted 202's are excepted, since all previously assisted section 8 recipients will be eligible to receive a Modified Certificate, irrespective of their incomes.)

The Secretary's authority under section 203(e) of the 1978 Act -- permitting the Secretary to request mortgagees to accept partial insurance benefits in lieu of an assignment -- also would be retained.

Finally, the proposal would repeal section 367(b) of the Multifamily Foreclosure Act of 1981, which authorizes and, in some cases, directs the Secretary to require a purchaser at a foreclosure sale to continue to operate the project in accordance with the terms of the section 312 loan program or insurance program under which assistance was originally provided.

The proposed amendments are designed to remove the current restrictions on the management and disposition of HUD-owned properties so that the Secretary can handle these properties on a business-like basis. The present law mandates a bias toward the continued use of the property for low- and moderate-income housing, without a realistic regard for the economic consequences to the government of such continued use. This is especially true given the more limited potential for success of already financially troubled projects.

The proposed amendments would permit the Secretary to dispose of properties on a sound economic basis, while extending to eligible tenants displaced from assisted projects the benefits of the proposed Modified Section 8 Existing Certificate Program.

PREVENTION OF FRAUD AND ABUSE IN HUD-ASSISTED PROGRAMS

Section 321 contains a number of provisions to help prevent fraud and abuse in HUD's assisted programs. Subsection (a) would require an applicant for assistance under HUD programs involving loans, grants, interest subsidies, other financial assistance of any kind or mortgage or loan insurance to (1) include his or her social security number or employer identification number on forms designated by the Secretary and (2) sign a consent form authorizing the Secretary to verify and audit information furnished by the

applicant and authorizing other government agencies and private sources to release information related to the determination of eligibility or benefit level or post-verification thereof. Information provided pursuant to this subsection would have to be confidential except for use pursuant to this section as determined by the Secretary. Such information would include, but would not be limited to, wages, unemployment compensation, VA benefits, and benefits under the Social Security and Food Stamp Acts. Failure to comply with the requirements of this subsection would be grounds for rejection of the application or termination of participation in the program involved. The Secretary would define the term "applicant" for purposes of this subsection.

Subsection (b) would amend section 303(d)(1) of the Social Security Act to authorize State unemployment agencies to release information to HUD and public housing agencies concerning applicants' wage information and unemployment benefits.

Subsection (c) would provide that the entity responsible for determining eligibility and/or level of benefits under the United States Housing Act of 1937, section 101 of the Housing and Urban Development Act of 1965 or section 221(d)(3) or 236 of the National Housing Act, including PHA's and owners of such projects, shall keep participation in the particular

program benefits to any applicant who knowingly and willfully made false or misleading statements, concealed any relevant facts or otherwise violated these Acts or any of their regulations.

Subsection (d) would amend section 214(b) of the Housing and Community Development Act of 1980 to extend the prohibition against financial assistance to certain aliens to include the 221(d)(3) program.

The Department must have social security numbers and employee identification numbers in order to make efficient and effective reviews of assistance eligibility and level, to reduce administrative error, and detect fraudulent transactions. The social security numbers are the only uniform and accurate means of identification, and their uniqueness makes it possible accurately to identify individuals in records of other agencies. Provision of the social security numbers and the applicant's consent to the Secretary obtaining data from other agencies, as required by subsection (a), would enable HUD to verify the accuracy of applicants' information and, accordingly, prevent fraud and abuse. The requirement to provide social security numbers is similar to that used in the food stamp program to prevent fraud. Additionally, the General Accounting Office has

recommended enactment of such legislation on a government-wide basis.

Access to data bases maintained by State unemployment agencies, as authorized by subsection (s), is needed to enable the Department to undertake post-audit, quality control, and other investigative reviews based on computer matching to such data bases. This amendment would help the Department to assure that complete and accurate information has been submitted by beneficiaries of HUD programs. The Department of Agriculture has been given similar authority in connection with its Food Stamp program.

Subsection (r) would provide clear statutory authority for public housing agencies and owners of projects assisted under the section 8, rent supplement, section 221(d)(3) and section 236 programs to disqualify applicants from eligibility for admission or for continued benefits if the applicant has made false and misleading statements or concealed relevant facts. The public housing agencies and owners of assisted projects would follow up and verify information affecting eligibility and benefits level based on data furnished by the Secretary. By allowing resolution of such matters at the local level, several goals are achieved. The Department will be providing a means for combatting fraud, assisting in most

collection efforts, and allowing for greater local administration of the program.

Since the 221(d)(3) program also provides a financial benefit to tenants, it should be included, as provided by subsection (d), along with the other rental assistance programs in the prohibition against financial assistance to aliens. Also, the amendment is needed to prevent the anomalous situation where some of the tenants in a section 221(d)(3) project are subject to the section 214 prohibition (rent supplement tenants) while others are not.

AMENDMENT OF REAL ESTATE SETTLEMENT PROCEDURES ACT OF 1974

Section 322 would amend the Real Estate Settlement Procedures Act by repealing sections 8, 9, 13, 14, 15 and 16 and by making several other minor changes.

Subsection (a) would repeal sections 8, 9, 13, 14, 15 and 16. Repeal of section 8 (Prohibition against Kickbacks and Unearned Fees) is proposed for two reasons. First, the Department has found that the abuses associated with direct cash payments or kickbacks do not occur so frequently on a nationwide basis as to warrant a Federal criminal statute and penalty. Second, developments in the settlement service industries in recent years indicate that this provision may impede the evolution of new, innovative methods for the

delivery of settlement services, such as the voluntary packaging of such services, which may ultimately lower consumer costs.

Section 9 (prohibiting seller-required use of a particular title company) is proposed for repeal because the Department has never been able to identify a significant abuse of the consumer in the area of seller-selection of the title insurer. While developers might pass on the cost of blanket mortgage title work directly to consumers by referring or requiring use of the title company doing the blanket mortgage search, such costs are invariably passed on to the consumers in any event. Moreover, difficult title problems, which the project insurer is willing to insure against because it has thoroughly examined the Record, might become an exception on another company's policies. This may frustrate settlement unnecessarily.

Sections 13, 14 and 15 relate to demonstrations and reports which have been completed, and are being repealed as obsolete. Finally, section 16 (relating to the jurisdiction of Courts) is being repealed, because the repeal of sections 8 and 9 would make it meaningless.

Subsections (b) and (c) of the Act make conforming changes in the Act's purposes and definitions occasioned by the repeals in subsection (a).

Subsection (d) would amend section 4(b) of the Act to delete the requirement that the borrower be permitted to examine the settlement form the day before settlement. The Department's experience indicated few consumers took advantage of this disclosure opportunity and many received the information from closing agents voluntarily. Additionally, the Good Faith Estimates disclosures required by section 5(c) of RESPA have proven sufficiently accurate to give a general idea of the total cost of settlement. Therefore, elimination of this requirement would not have an injurious effect on consumers, but would remove the Federal government from one aspect of residential real estate transactions.

Subsection (e) amends section 5 of the Act relating to distribution of booklets to clarify the law and to reflect the existing practice of the Department of furnishing only the text for the booklet while the lenders themselves purchase the booklets from vendors.

Subsection (f) makes a technical change in section 10 of the Act (Escrow Accounts), relating to escrow collection. In a very few circumstances (primarily involving real estate taxes), the existing statutory formula for the prepayment of taxes and insurance has provided insufficient funds to meet the obligation when it first comes due after closing. The

amendment would permit a sum to be collected sufficient to avoid a shortage from occurring.

Subsection (g) is a technical amendment to section 12 of the Act, deleting a reference to section 6, which has already been repealed.

HOUSING COUNSELING ASSISTANCE

Section 323 would amend section 106(a) of the Housing and Urban Development Act of 1968 to eliminate all funding for grants and contracts under the Housing Counseling Assistance Program and other activities specified in that section. In this regard, the Secretary's authority to make grants or contract for housing counseling and other activities as authorized by section 106(a) would be stricken. The authorization for appropriations under 106(a)(3) for housing counseling would be repealed. Additionally, section 101(e) of the Act, which authorizes housing counseling assistance for mortgagors under section 235(i) or 235(j)(4) of the National Housing Act, would be repealed. Finally, section 230(d) of the National Housing Act, which directs the Secretary to provide housing counseling to persons assisted under the TMAP program, would be repealed.

Localities can use other sources of Federal revenues (such as community development block grants and general revenue sharing) to fund the activities specified in the above

authorities. Accordingly, all authority to appropriate funds for grants and contracts for these purposes (including the Housing Counseling Assistance Program) would be eliminated. However, HUD's authority to provide information, advice and technical assistance for the purposes contained in these provisions would remain unchanged. For example, HUD staff could continue to work with housing counseling agencies that provide mortgage default and rent delinquency counseling on a voluntary basis. The HUD staff activity would include approving counseling agencies and providing technical assistance, making referrals of delinquent mortgagors to counseling agencies, and using counseling agencies to help keep forbearance agreements current. The only expenditures to the Federal government under section 106(a) for the provision of these services would be the salaries and related expenses of the HUD employees involved.

Chairman GONZALEZ. Thank you, Mr. Secretary.

I regret very much that at no point have you addressed yourself to the bill that is the basis of these hearings and was introduced as early as March 4, H.R. 5731, which every single member on the majority side of this subcommittee has cosponsored.

Therefore, I will defer from asking the specific questions I intended to ask and instead ask that you respond to them in writing.

[The questions follow:]

QUESTIONS SUBMITTED BY CHAIRMAN GONZALEZ

Question 1. I share your concern of soaring housing costs as expressed in your testimony, but I don't see how the actions being taken by this Administration will solve this problem. My understanding is that because of the recession the network that is needed to produce housing is collapsing. I am referring to the lumber industry, the contracting industry, and the appliance, roofing and plumbing industry. If this network is substantially reduced, when the recovery comes it seems to me that housing costs will only increase because of the shortage that will exist in these industries. What are your thoughts on this, Mr. Secretary?

Answer. As I stated in my testimony, the hardships which have been imposed on homebuilders and others in the shelter industry have been caused by double-digit inflation and high interest rates. This is a situation that has developed over many years, and it cannot be corrected in a few months. We believe that reducing inflation and interest rates are the most important actions that this Administration can take to help control housing costs.

We are already seeing some indicators that economic recovery is underway, with increases in building permits and housing starts and a dramatic decline in the rate of inflation in the past few months. When the Nation becomes confident that inflation has finally been brought under control, interest rates should decline, and we will once again see housing production climb back to the levels needed to keep pace with demand.

In the meantime, we are taking a number of steps to help the shelter industry survive these difficult economic times, using those resources available to us to provide an immediate boost for housing construction. In the last two months, we awarded $1.973 billion in mortgage purchase commitments under the GNMA Tandem program, providing assistance to 463 Section 8 projects. We are using the Financing Adjustment Factor technique to make other Section 8 projects economically feasible despite flucuating interest rates. We are continuing to provide direct loans for the construction of elderly and handicapped housing under the Section 202 program.

Nevertheless, the Administration recognizes the severe problems affecting contractors, subcontractors, and material suppliers during this interim period. Undoubtedly, many marginal companies will not be able to compete during this period when the level of housing production is down. But we believe that the financially sound companies *can* survive, and will grow and prosper as housing construction picks up. During this slow period, some stockpiling of building materials has occurred, and suppliers anxious to move these materials out of their warehouses will help keep costs down. The Department is doing its part to hold the line on housing costs by eliminating unnecessary regulatory constraints, by simplifying processing procedures, and by reducing the time required to obtain FHA mortgage insurance.

In summary, we believe that any nominal increase in the cost of housing will be compensated for by reduced interest rates and more efficient housing production.

Question 2. On page 6 of section-by-section summary of the bill you explain that the Rental Rehabilitation Program can provide comparable assistance to that provided under the Section 8 Moderate Rehabilitation Program to 40 percent more families and to 40 percent more units at the same cost. Would you please provide the details of that analysis and show the comparative total cost over the standard contract period for a section 8 moderate rehabilitation contract. Include in the total cost the estimated use of CDBG or other federal funds. What percentage of income will a family whose income is 35 percent of median or below be likely to pay annually over 15 years under both alternatives?

Answer. The basis for the statement that the [illegible]ntal [illegible] li[illegible]on Pr[illegible]am [illegible] provide comparable assistance to that provided [illegible] bilitation Program to 40 percent more families [illegible] percent more [illegible] same cost is as follows.

The Section 8 Moderate Rehabilitation Program is budgeted at $4,580 per year per unit for 15 years (revised fiscal year 1982 HUD budget). That is a total budget authority of $68,700 per unit. The present value equivalent of 15 years of payments at $4,580 per year (using a 12 percent discount rate) is $31,193.76 per unit. Modified Section 8 certificates are budgeted at $2,000 per year. If we assume a cost of $2,500 per year for the modified certificates (to allow for some inflationary adjustment) the present value of 15 years of modified certificates is $17,027.16. If the $5,000 per unit budgeted for rehabilitation under the Rental Rehabilitation Program is added to the present value of the modified certificate, the total present value cost of the unit rehabilitated and 15 years of tenant assistance is $22,027.16. That is $9,166.50 less than the Moderate Rehabilitation unit. Ten thousand units of Moderate Rehabilitation would have a present value cost of $311,927,593. That same amount would produce 14,162 units in modified certificates under the Rental Rehabilitation Program—a 42 percent increase.

The above figures for the Section 8 Moderate Rehabilitation Program do not include the use of CDBG or other funds. CDBG funds were often used with the Section 8 Moderate Rehabilitation Program, but the amount varied considerably from locality to locality, and the Department does not have an accurate average figure for CDBG funds used.

In the above comparison, the assumption is that the same rules would be used to determine the percent of income to be charged the very low income tenant for his portion of the rent cost.

Question 3. What analysis has the Department completed that compares what would happen to families over a 15-year period in a tight rental market under your modified section 8 proposal and under the existing Section 8 Program. What will happen to a family of 6 whose income is 25 percent of area median, 40 percent of median, or 65 percent of area median?

Please compare the market rents, as well as the percentage of income that will have to be paid for rent.

Answer. The Department has done extensive analysis on the impact of the modified Section 8 proposal both on households and on the budget. All of our analysis however, has been limited to the first five years of the program because of the many uncertainties that are involved in longer projections.

The attached Table 2 presents a side-by-side comparison of what will happen to a family of 6 whose income is 25 percent, 40 percent and 65 percent, respectively, of area median. In each case we assumed that the family had previously (1982) been assisted by the Section 8 Existing housing program and had lived in a unit that rented at the Fair Market Rent (FMR). We further assume that the rent for the unit will increase with the Consumer Price Index (CPI). Table I presents the year to year increase in the CPI that we used.

Incomes in 1983 and yearly changes to income are shown in Table I. The adjusted incomes shown in Table 2 assume that families would have the typical deductions as per the current rules. We assumed that the rules would not change over the five year period.

As requested, Table 2 presents the analysis for a family of six. This is not a typical family. The average household in the Section 8 Existing housing program at this time contains less than 3 persons. The first panel of table 2 shows that families with incomes at 25 percent of median in the two programs would have almost identical rent burdens (the percentage of income paid for rent) in 1983. The difference widens year by year until there is an 11 percent difference in 1987. This assumes that families in the modified program will remain in their 1982 units throughout the five years. Actually, some families will seek less costly units on the private market.

The third panel of Table 2 shows the comparison for families with incomes at 65 percent of median. Because the subsidy decreases as income increases, the families in this group would not get a subsidy. Under either program, they would be able to afford a unit renting at the Fair Market Rent without government assistance.

For ease of presentation, these estimates assume that families in all cases do not receive income from food stamps. If this were not the case, the comparisons would not change substantially since the additional income would affect families under the two programs in almost the same way.

If food stamps were included, family contributions as a percent of income would be higher for both programs.

TABLE 1.—YEAR-TO-YEAR CHANGES IN INCOME AND RENTS USED IN ESTIMATES

[In percent]

	1983	1984	1985	1986	1987
Income change	6.4	5.6	6.9	6.7	6.5
Rent change	6.5	5.1	4.8	4.6	4.5

Table 2

Subsidy and Rent Burden Estimates for a Family of Six with Incomes at 25%, 40% and 65% of the National Median

	1983		1984		1985		1986		1987	
	Extg	Mod	Extg	Mod	Extg	Mod	Extg	Mod	Extg	Mod
FMR/ Pymt Std.	5032	4353	5359	4636	5632	4872	5903	5106	6174	5341
Rent	5032		5359		5632		5903		6174	
25% of Median										
Adj. Income	6410		6930		7415		8045		8699	
Subsidy	3301	3244	3419	3213	3482	3057	3489	2813	3564	2622*
Family Contrib.	1731	1788	1940	2146	2150	2575	2414	3090	2610	3552
Rent Burden	27%	28%	28%	31%	29%	35%	30%	38%	30%	41%
40% of Median										
Adj. Income	11288		12121		12896		13904		14951	
Subsidy	1984	1883	1965	1580	1892	1305*	1732	1305*	1689	1305*
Family Contrib.	3048	3149	3394	3779	3740	4327	4171	4598	4485	4869
Rent Burden	27%	28%	28%	31%	29%	33%	30%	33%	30%	33%
65% of Median										
Adj. Income	19419		20772		22031		23570		25371	
Subsidy	0	0	0	0	0	0	0	0	0	0
Family Contrib.	5032		5359		5632		5903		6174	
Rent Burden	26%		26%		26%		25%		24%	

Note: These estimates assume that the family does not receive income from food stamps. The estimates for the modified program ("mod") limits increases in family contributions to 20 percent per year as per the legislation. The existing Section 8 program is designated "Extg".

*Designates the maximum subsidy that the family can receive

Question 4. Do I understand that the new Rental Rehabilitation Program is to be funded out of the $4.166 authorized for CDBG and UDAG for fiscal year 1983 and would in effect be reducing the funds available for those purposes by $150 million?

Answer. The funding request is not part of the Block Grant, or the Urban Development Action Grant authorization. The Department is proposing a $150 million authorization and appropriation for the Rental Rehabilitation program, separate from the Community Development Block Grant and Urban Development Action Grant authorizations.

Question 5. Would you provide for the record a list of the cities that would be entitled to funds for the Rehabilitation Grant pursuant to the criteria described in Section 122(b)(1) and approximately how much each city would receive if $150 million were appropriated.

Answer. HUD estimates that approximately 250 cities with a population of 50,000 or more and urban counties will receive direct allocations of Rental Rehabilitation Program funds, with grants ranging in size from $100,000 to around $10 million. Most of the cities expected to receive their own grants will have populations in excess of 100,000. These allocations will utilize 55–60 percent of available funds. The remainder of the monies will be allocated to each of the states or, in the event any state does not choose to operate the program during fiscal year 1983, HUD field offices.

HUD does not yet have a specific list of cities/counties to be funded and the proposed grant amounts. The factors described in Section 122(b)(1) differ from formula elements used in other Departmental programs, and no census runs have been completed for the proposed factors. The task of preparing and analyzing new data is underway. HUD will provide the Committee with more detailed information as soon as the information is available.

Question 6. Does anything prohibit an owner of a building rehabilitated with assistance from the program from raising the rent beyond payment standard for Modified Section 8 Certificates after the first year and eventually to raise the rents so high that a tenant receiving Modified Section 8 assistance would be required to pay more than 30 percent of his income for rent?

Answer. The purpose of the Rental Rehabilitation Program is to increase the supply of private housing, of a decent quality, available in the private market and affordable to households holding Modified Section 8 certificates. The rehabilitation program will thus greatly facilitate the smooth functioning of the certificate program. The Administration's proposal for a Modified Certificate Program is the most cost effective way of meeting the housing needs of very low income persons.

The program standard built into the Rental Rehabilitation Program which directs that 80 percent of the units rehabilitated should be affordable at market rents to persons with certificates will ensure that the vast majority of housing units rehabilitated will, in fact, be affordable to certificate holders. We expect that local governments will assure that result by selecting neighborhoods with depressed rental markets in which rental units meeting the standards of the Section 8 Existing Program, in fact, have market rents within the Section 8 payment standard. Rental increases in those neighborhoods will generally not be at any higher rate than general rental increases in the locality as a whole. It is to be expected that the vast majority of the units rehabilitated will, over the years, remain affordable for a long period to certificate holders.

Question 7. What is the average income of homeowners in the urban homesteading program and what is the range of incomes of urban homesteaders? How is the distribution of incomes of participants likely to change if the Department requires the payment of consideration which could be as much as half of the average acquisition price?

Answer. Income data on Urban Homesteading is not available for fiscal years 1980 and 1981. However, over the first three years of the demonstration (1976-1979), average homesteader incomes increased from just under $12,000 for a family of 3.2 persons to almost $17,000, reflecting inflation.

The proposed legislative amendment does not *require* the payment of consideration for properties acquired through the Urban Homesteading Program. It would permit the payment of consideration, based upon the value of the property, the level of rehabilitation required, and the income of the homesteader, thereby eliminating the unnecessarily high subsidy to middle income homesteaders. As proposed, we do not think that the distribution of incomes of participants would change significantly.

Question 8. What will the impact be on the amount of rent a tenant will have to pay in relation to their income for the 60,615 families now receiving

under the regular section 8 existing program if they are transferred to the modified section 8 certificate program?

Answer. The law, as proposed, will limit the increase in rent that a tenant will have to pay to 20 percent in any one year. A typical family in the modified program will have a 1983 rent burden only one percentage point greater than they would have had if they had stayed in the section 8 existing program.

Question 9. Why couldn't it be possible under the existing section 8 program to develop an incentive to encourage families to find rental units that cost less than the applicable fair market rent?

Answer. This is what we have done. The modified section 8 existing program is simply an extension of the present section 8 existing housing program with a very strong "shopping incentive".

Other types of incentives are possible and one was tried when the program was initiated in 1974. That incentive shared the cost savings that were obtained when a tenant rented below the FMR between the government and the family. The incentive was presented in a very complicated fashion. Research showed that most PHAs and tenants didn't understand the incentive or use it.

The present modification uses the same formula that was shown to be very successful in the Experimental Housing Allowance Program (EHAP).

Question 10. Why is your justification for not increasing the amount of assistance provided to a family over a 5-year period in your modified section 8 proposal? Are you assuming rents won't increase, that a low-income tenant's income will keep up with any rent increases? What happens if a family's income decreases during those five years?

Answer. Our primary consideration in drafting the modified Section 8 proposal was budget responsibility. In order to subsidize the full number of units that are projected within budget estimates for the five year term of the annual contribution contract, it was necessary to place a ceiling on the maximum subsidy that a family could receive. This ceiling is the maximum amount that a family is entitled to when it first enrolls.

As our response to question 3 shows, the program has a provision which limits the increase in a previously assisted tenant's contribution to rent to 20 percent per year. This will protect families from large increases in their rent when they transfer from the Section 8 Existing housing program.

We make no assumptions concerning rents and incomes. In all likelihood rents will continue to rise and they may or may not outstrip the increases that may occur in tenants' incomes. One of the strengths of this proposal is that it allows tenants to rent above or below the payment standard as they see fit. In the face of a subsidy ceiling and rising rents, many tenants may be prompted to make an extra effort to find standard units renting below the payment standard. This will keep their contribution to rent low.

The subsidy cannot increase above the amount a family is entitled to at enrollment. If the family's income increases relative to rents, the subsidy will go down. If at a later point the family's income decreases again, the subsidy can again rise, but only to the point where it is equal to the amount the family was entitled to at enrollment.

Question 11. You state that the Administration's program will increase the number of subsidized households from 3.3 million to 3.8 million by the end of fiscal year 1985. This is an increase of roughly 166,000 units per year for the next 3 years. Aren't most of these units those already in the pipeline?

Excluding these, how many new units will your proposals add to the housing stock?

Answer. Except as noted below, the increase in the number of subsidized households from 3.3 million to 3.8 million by the end of 1985 will come entirely from units now under reservation. The 3.8 million household estimate was derived by taking the current number of units under reservation less an assumed level of project cancellations and fallout during 1982–1985. While the bulk of the Department's subsidized housing activity after 1983 will be the conversion of units to the new modified certificate program, our budget also assumes funding for new units under two categories: Section 8 will be used in conjunction with new Section 202 projects and with the Rental Rehabilitation initiative. The table below indicates projected number of units reserved under these two categories during this period.

ADDITIONAL SUBSIDIZED HOUSING UNITS, FISCAL YEAR 1983–85

	1983	1984	1985
Section 8/202	[illegible]	[illegible]	[illegible]
Section 8 certificates with [illegible]	30,000	[illegible]	[illegible]

Question 12. A multitude of problems have been caused by the decision to limit section 8 cost increases to 7¾ percent annually. Just recently I have learned that two projects that received preliminary reservations in 1980, firm commitments for FHA insurance in January 1982 and were successful in the recent tandem lottery will not proceed because of the 7¾ percent limitation unless one nonprofit sponsor raises an additional $[illegible],000 and the second nonprofit sponsor raises an additional $600,000. Each of these projects have also received over $400,000 in CDBG funds. There is clearly a wide discrepancy between the mortgage amount FHA determined was appropriate for. insurance purposes and the mortgage amount that is supportable under the Section 8 contract. Surely it is inappropriate, this late in the process, to change Departmental policy and to threaten the construction of badly needed projects. What will you be doing to solve this and other problems caused by the application of the 7¾ percent cost containment provision.

Answer. The Department recognizes that the imposition of cost containment standards will cause difficulty for sponsors who were used to the more open-handed way that Section 8 was administered in the past. Nevertheless, our Administration is committed to bringing the cost of the housing subsidy program under control. Limitations on cost-overruns are one of the ways we can achieve this goal.

Question 13. There have been a number of instances lately where the Committee has expressed its concern that the Department has been changing policies via field notice or memorandum which perhaps should be more appropriately dealt with through the formal rule-making process.

This was the situation that prompted our recent hearing on the Section 202 Program, as one example. Another instance which comes to mind is the Department's current efforts to alter the public housing operating subsidy formula to meet the shortfall for 1982.

A legal opinion prepared for the Subcommittee indicates that the courts have determined that when an agency action affects the rights and interests of parties, the agency must follow the rulemaking procedures of the Administrative Procedures Act. HUD has by its own regulations declared that it is subject to the APA. What guidelines does HUD use to ensure that its actions which affect the rights and interests of parties are carried out according to requirements of the Administrative Procedures Act? Have these guidelines been distributed to the various office within HUD?

Answer. The general guidelines that assure the Department's compliance with the Administrative Procedure Act (APA) are set forth in 24 CFR Part 10. Further, more specific guidelines for determining what are APA covered actions—i.e., whether a Departmental action is one for which rulemaking procedures are required—are contained in HUD Handbook 010.1, which has been distributed to all program offices in HUD. Generally, HUD policy requires that virtually all of the Department's substantive policies for the programs it administers, procedural requirements which must be met in order to participate in the programs, and major interpretations of program policies or procedures which are of general applicability be published in the Federal Register. Issuances not published in the Federal Register may elaborate or expand upon the published materials but may not modify the substance of those published materials or establish new program policies, requirements or procedures.

Question 14. You are projecting a decrease in the average per unit cost figure for Section 202 from $57,550 in 1982 to $45,352 in 1983. Could you provide the Committee with a detailed analysis of how these cost savings are to be achieved? What portion of this projected $12,200 per unit cost savings is attributable to each of the specific cost containment proposals?

Answer. The 1983 Budget assumes an average unit cost for the Section 202 program for Fiscal Year 1982 of $48,300, and for Fiscal Year 1983 the estimate is $42,300. The lower estimate for Fiscal Year 1983 reflects HUD internal requirements concerning amenities, which would reduce the average unit cost by 12.5 percent.

The $6,000 per unit difference between the Fiscal Year 1982 and Fiscal Year estimates reflects HUD's policies regarding cost containment and modest (

Our cost containment procedures do not mean that HUD tolerates cheap construction, poor workmanship or inadequate design. It means that every proposal must be carefully examined to assure that the design is not excessive in terms of amenities and cost of materials. Excessive amenities include such items as bowling alleys, swimming pools, saunas, Jacuzzis, balconies, atriums, dishwashers and individual unit trash compactors.

The cost containment savings of $6,000 reflects an average for various projects. Because different projects will incorporate different cost containment items and project size will vary, the savings per unit will also vary. Therefore, it is not possible to attribute unit cost savings to each specific cost containment proposal.

Question 15. Could you provide the Subcommittee with an estimate of how many assisted housing units are necessary as a result of court ordered settlements or settlements between HUD and local communities arising from HAP compliance under the CDBG program? Are the units needed to meet these court requirements and other HUD settlements included in your Fiscal Year 1983 proposals? If they are not, why not, and how do you then propose these settlements will be met?

Answer. Based on recent trends, we would expect to provide assistance for approximately 700 units as a result of court-ordered settlements and another 800 to 900 units for settlements to achieve HAP compliance during Fiscal Year 1983. Assuming no major new litigation or other changes in these trends, the Department should have no difficulty in providing this assistance from recaptures of existing contract and budget authority.

Question 16. For those uninsured 236 projects covered by Rent Assistance Payments (RAP), what source will be used to cover cost increases?

Answer. The budget assumes that State agencies which have financed the uninsured Section 236 projects will be responsible for meeting any necessary cost increases beginning in Fiscal Year 1983.

Question 17. A number of rent supplement projects are in financial difficulty as a result of unfunded Fiscal Year 1981 rent supplement shortfalls. The Administration plans to convert the insured projects to Section 8 whereas the uninsured state agency projects will not be funded. How does the Department plan to take care of the uninsured Rent Supplement projects over the long term?

Answer. The budget assumes that the appropriate state housing agency will be responsible for funding any necessary cost increases in uninsured Rent Supplement projects after 1983.

Question 18. At one time the Department was considering converting RAP projects to Section 8 and using the RAP assistance to assist uninsured projects. Have you abandoned this approach and if so, why?

Answer. The Department believes the funding of amendments for uninsured State Agency projects is a responsibility of the State Agency, not HUD.

Question 19. Would you have the Department's housing and legal staffs review the new rental production program contained in H.R. 5731 and provide the Subcommittee with a technical and legal analysis as to its provisions?

Answer. Part B of title III would authorize the appropriation of $1.3 billion to States and local governments to stimulate the construction and rehabilitation of multifamily housing projects and cooperative projects.

While the Department has not had sufficient time to complete a technical and legal analysis of the bill we do have some initial comments regarding it. Generally the Administration opposes narrow purpose legislation, such as this, which authorizes the expenditure of significant amounts of Federal revenues and adversely affects the economy by adding to the budget deficit. The best way to stimulate greater production of housing is to reduce the cost of borrowing money either to construct or to purchase housing. Moreover, to the extent the bill is intended to assist lower income families, subsidized new construction is the less cost effective means of providing such assistance. On the other hand the Administration bill, H.R. 6020, strikes the proper balance between increasing the availability of multifamily housing and maintaining overall Federal fiscal integrity. The Rental Rehabilitation Program initiative will help preserve the nation's housing stock in low-and-moderate income neighborhoods while the new modified Section 8 Existing Housing Program will bridge the "affordability gap" for very low-income renters in the private market at a much lower cost than subsidized new construction.

Question 20. The new rental production program contained in H.R. 5731 contains various eligibility criteria including extent and change in the level of poverty, housing overcrowding, the amount and duration of rental housing vacancies, the amount of substandard rental housing, and the extent of rental housing production lag. Based on these criteria, could HUD provide the Subcommittee with an analysis of

which areas would be eligible under these criteria? Do you have any recommendations as to other criteria that would be appropriate?

Answer. We do not have the information at this time. It will be submitted when estimates can be made.

Question 21. Over the last several years, HUD has provided set-asides of Section 8 authority for use under the "loan management" program. This provides needed rental assistance for HUD-insured projects that are in some form of financial difficulty, and which can't be assisted under the Troubled Projects Program. I notice that in your budget proposal for 1983 there is no mention of a loan-management set-aside. I hope this is merely an oversight on HUD's part and not a change in your policy, since it seems to me to make eminent sense to prevent these projects from defaulting and causing losses to the FHA Fund. What are the Department's plans for the loan management activities for 1983? What are your projections for the need for Section 8 assistance among these projects in 1983, and will you be making any Section 8 authority available to take care of these projects?

Answer. The Department intends to convert all insured rent supplement and RAP projects during 1983–1985. This will mean a significant reduction to the number of units potentially eligible for direct loan management assistance. HUD does not intend to make available any additional Section 8 assistance in order to "bail out" other insured projects. The budget assumes that an improved economic environment, combined with better management and higher rents where necessary, will minimize the number of claims that might otherwise occur from a failure to provide additional Section 8 subsidies for these projects.

Question 22. I understand HUD has just received a preliminary research report on the comparative long-term costs of public housing and Section 8 new construction. I also understand that the report shows that if these programs are compared on the basis of development costs, as well as long-term operating costs, Section 8 new construction is the better program. Would you comment on these findings and provide us a copy of the preliminary report?

Answer. The study referenced in your question is "The Costs of HUD Multi-family Programs: A Statistical Analysis of Development, Financing, and Subsidy Expenditures." The draft is still being revised, and it is not possible to provide a copy at this time. However, at the request of Senator Armstrong of Colorado, a report is currently being prepared regarding the development and long-term subsidy costs of housing subsidy programs, and we will be relying heavily on the draft study in preparing that report.

Question 23. Section 309 of the FNMA Charter Act requires the HUD Secretary to review the financial operations of Fannie Mae and undertake a study of the extent to which its activities meet the purposes of its charter act. This study was to be transmitted to the Congress by July 1, 1978.

It is my understanding that this study has never been transmitted to the Congress. What is the status of this report and when will it be submitted to the Congress?

Answer. Section 309(h) of the FNMA Charter Act was amended in 1977 to require the Secretary to conduct a special review of the financial operations of FNMA and to study the extent to which FNMA's activities were meeting the purposes of the Charter Act. The legislative history is silent as to what prompted this requested inquiry. The review and study report were to have been completed and transmitted to the Congress on or before July 1, 1978. This requirement was added by Section 408(c) of Public Law 95-128, approved October 12, 1977. The review itself was completed in 1978, and although several drafts of the study report had been prepared by early 1980, a final report was not completed or transmitted to Congress. The current Administration has no knowledge whether the choice not to transmit a final report was deliberate or, if so, what considerations entered into that choice.

Since early 1980 there have been great changes in the housing industry and the secondary mortgage market. The facts and assumptions prevalent in 1977 about finance in general and about FNMA's operation in particular are no longer valid.

Under new leadership FNMA recently has undertaken a number of new financing initiatives to enable it effectively to serve the interests of homebuyers in a changing marketplace while stabilizing and increasing its corporate revenues. The work that was done in 1977 and 1978 in studying and reviewing FNMA's operations as then conducted would no longer be useful. A new study of the financial operations of FNMA would obviously require a major outside contract [illegible] be [illegible] ve of FNMA's continuing efforts to re-establish profitability a[illegible] The Department therefore recommends against any renewal [illegible] dertake this study.

Question 24. Over $21 million has been appropriated for the Solar and Energy Conservation Bank but HUD has yet to issue regulations. The Comptroller General issued a report on January 25, 1981, stating that because of the mandatory allocation requirements of that program, section 1001(4) of the Impoundment Control Act precludes the application of the Act to support the deferral. A similar argument applies to a rescission request. Given this analysis, what steps are you taking to implement the program as required by law?

Answer. The HUD Appropriation Act of Fiscal Year 1982 (Pub. L. 97-101, enacted December 23, 1981) provides $21,850,000 to implement the Solar Energy and Energy Conservation Bank program. On February 5, 1982, the President proposed a rescission of these funds. Rescission Proposal No. R82-22, H. Doc. 97-140, p. 27. The 45-day period during which funds covered by a rescission request may be withheld from obligations expired on April 23, 1982, and the funds appropriated were apportioned for use by OMB on April 26. Secretary Pierce has designated Robert Karpe, President of the Government National Mortgage Association, as Manager of the Bank, empowered to exercise the functions of the President of the Bank pending nomination and confirmation of a Bank President. As Manager, Mr. Karpe is overseeing the development of a Bank program appropriate to the appropriation level for presentation to the Bank's Board of Directors and implementation.

Generally, funds proposed for rescission or deferral under the Impoundment Control Act of 1974 are withheld from obligation during the 45-day period. The Comptroller General has acknowledged the propriety of this practice under normal circumstances in the past. 54 Comp. Gen. 453(1974). An exception to the general rule would be an impoundment of funds authorized by a mandatory spending statute as described in the so-called "fourth disclaimer" of the Impoundment Control Act, 31 U.S.C. Section 1400(4). The Comptroller General has acknowledged that the Office of Management and Budget does not concur in his interpretation of the scope of the "fourth disclaimer." Having complied with the Impoundment Control Act's requirements and absent any knowledge of a violation of a related statute, we believe the impoundment during the 45-day period was in accordance with law.

Question 25. Pursuant to the Federal National Mortgage Association's Charter Act, the Secretary of HUD has regulatory authority over Fannie Mae. Section 309 of the Charter Act provides the Secretary with the authority to examine and audit Fannie Mae's books and financial transactions. It also provides that he may require Fannie Mae to make such reports on its activities as he deems advisable.

What steps has HUD taken during your Administration to review Fannie Mae's financial operations, and what financial reporting have you required of Fannie Mae?

Answer. Section 309(h) of the FNMA Charter Act grants the Secretary of HUD the power to make rules and regulations concerning FNMA and to require FNMA to make such reports on its activities as the Secretary deems advisable. Pursuant to this authority, and following the completion of the Departmental review of FNMA's operations under Section 309(h), regulations were adopted on September 14, 1978 which require certain reports from FNMA concerning its financial operations. Specifically, 24 CFR Section 81.22 requires FNMA to submit annually a business activities report, and 24 C.F.R. Section 81.23 specifies nine additional reports which must be submitted by FNMA. These reports continue to be analyzed by HUD staff to determine whether or not the purposes of the Charter Act are being accomplished. Although the Secretary has the authority to examine and audit FNMA's books and financial transactions, he is satisfied that the financial reports presently required by FNMA enable him adequately to review FNMA's operations.

In addition, numerous meetings have been held with FNMA to discuss FNMA's current affairs, particularly in connection with requests for approval of new FNMA program initiatives as well as the FNMA Chairman's desire to keep HUD informed of FNMA's position. These contacts have supplemented the information contained in the formal reports and have kept the Department abreast of FNMA's financial status.

Question 26. I have received your letter of March 18 in which you inform the Subcommittee that the study of alternative methods for allocating operating subsidies requested in last year's Reconciliation bill will not be submitted on time.

My recollection is that the Congress specifically requested the study by March 1 of this year so that it could develop better and more efficient approach to funding operating subsidies THIS YEAR.

We are faced with a situation where operating subsidy costs are escalating, and where this Administration has refused to face the reality of these costs. We in the Congress feel the time is long overdue to address this problem.

The Subcommittee will be marking up its legislation the end of April and we plan to legislate with regard to the operating subsidy funding. This study would, of course, be invaluable to us in that effort.

Will this study be available to the Subcommittee by April 15 so that we can use its findings as a basis for legislating as we had intended?

Answer. The PHA Operating Cost Study has been drafted and is now undergoing clearance. It provides an analysis of several long term alternatives for allocating operating subsidies for the public housing program. However, you should know that the research is not of immediate value for the analysis of the operating subsidies required for this year. One reason for this is that the budget estimates used in evaluating the alternatives are stated in 1980 dollars and assume the full phase-in of 30 percent of income as a rent contribution by tenants. The resulting comparison between possible alternative subsidy systems are therefore internally consistent, but not stated in terms which are relevant to current budget discussions for fiscal 1983.

Question 27. Currently HUD regulations allow public housing authorities to request year-end adjustments in utilities expense levels where the PHA's costs differ from the estimate. However, I understand that HUD is requiring each PHA when they receive their final payment for fiscal year 1981 to sign on the dotted line that they will not ask for reimbursement for any utility cost they may have incurred not covered by the 1981 payment. Can you explain to the subcommittee what legal ground HUD is basing this decision on and how HUD expects the PHAs who have overruns, especially due to utility rate changes, to meet these additional costs?

Answer. This was an administrative decision. If PHAs have overruns, they will have to absorb them.

Question 28. I would like you to respond for the record to some concerns that have been raised regarding the Administration's proposal to change the operating subsidy allocation formula for the current year, fiscal year 1982. Please respond to each specific point that is addressed.

Private market housing in general cannot be compared to public housing in this simplistic way, because of differences in the characteristics of the stock, such as age, physical characteristics, unit sizes, condition, deterioration, etc.

The data even for private market units is not reliable and readily available.

The proposal penalizes PHAs that made extra efforts to conserve energy prior to 1976, since their consumption levels will be reduced based upon 1976–81 private market trends.

HUD controls the means by which PHAs can reduce consumption, namely through modernization funding, and the mandatory consumption reductions do not take modernization funding into account, except for the additional reductions mandated wherever "energy-related" modernization has been done.

For PHAs that have done better than the private market at energy conservation, their incentive to conserve further will be removed, since their consumption level is reduced to the prior year's level, not simply to the private market average.

HUD has already determined what the consumption reduction is going to be, in order to meet HUD's need to reduce operating subsidy. If the Regional Office's calculations don't fit the range predetermined by HUD Central, the assumption is that the calculations are wrong, and a minimum 5 percent reduction will be used.

The adjustment factor will be applied to new projects as well as to old ones. It is illogical to apply consumption reductions based on the period 1976–81 to projects that may be only a few years old. In addition, newer projects were probably built to more energy-conserving standards, and therefore don't have as much potential for further energy savings as older projects.

New Comprehensive Modernization (CIAP) projects have not been in place long enough to have their paybacks determined.

The proposed procedures will effectively eliminate all incentives for energy conservation.

The 50/50 share in energy conservation savings currently allowed to PHAs will be subject to "availability of appropriation" and will probably be entirely eliminated in fiscal year 1982. This totally eliminates all incentive to energy conservation. PHAs will be in trouble in years with cold heating seasons, and won't be able to recoup their losses in years with mild heating seasons. They will therefore be increasingly squeezed.

Water and sewer expenditures have been inexplicably lumped together with fuel costs, and reductions mandated for these, too, although they have nothing to do with energy conservation.

One single factor will be applied to the PHA, to calculate its mandatory reduction in energy consumption, regardless of its fuel mix. If the PHA's fuel mix is not the

same as the fuel mix for the private market housing in the region, there may be serious inequities in the factor applied.

Conversion of all fuels into a BTU figure, for purposes of calculating this per cent reduction factor, is almost impossible to do because of the different energy efficiency factors of various fuels, especially electricity. There should at least be separate factors for each fuel type.

Requiring the fiscal year 1981 figure to be used in all cases where it is the lowest is inequitable. It doesn't allow for Heating Degree Days. If there was a mild winter that year, PHAs would be unfairly held to the same level in subsequent years.

The procedure results in double-counting savings that theoretically are produced by modernization expenditures.

Answer. The methodology for the establishment of "reduction factors" as set forth in the Department's memorandum to Regional Offices on March 16, 1982 is not, and was not intended to be, a precise measurement of energy conservation. Rather, it was intended as a basis for the establishment of reasonable energy conservation *goals* that would reflect local operational practices, improvement of facilities and a public housing agency's (PHA's) own accomplishments. This action was taken because of a concern that stronger management incentives were necessary to achieve improved energy conservation performance on the part of PHAs and because the formula for the calculation of operating subsidies, the Performance Funding System (PFS), uses consumption during a fixed base period as a basis for the cost projection. A further reason was the need to contain operating subsidy costs within the appropriation available.

Departmental studies of PHA utility consumption indicated that an average reduction of 10 percent has actually been realized as compared with the fixed base period. Consequently, the Department believes that many PHAs will already have reached the objectives developed pursuant to these procedures, and that the limits established in the procedures assure reasonable determinations attainable by all PHAs. Subject to the availabilty of funding, however, the PFS includes a "safety valve" in that half of all consumption in excess of the Allowable Utilities Consumption Level (AUCL) can be reimbursed through increased subsidy payments.

On the whole, we believe our actions are responsive to the Directive of the House Appropriation Committee as stated in the report on the Supplemental Appropriations and Rescission Act of 1981, as follows:

"While in some cases increases in consumption of utilities are justifiable, the Committee believes that every possible incentive for conservation must be utilized. Therefore, a provision has been included in the appropriation language which gives the Secretary discretion to reduce payments to housing authorities that have not added units or demonstrated reductions in fuel consumption.

The Committee also believes that the three-year base period and the thirty-year 'heating degree day' average may not be an efficient way to compensate for PHA utility expenses because it may reward excess consumption and does not provide a sufficiently strong incentive to conserve energy resources.

The Committee strongly opposes the payment of Federal funds to PHAs that have not demonstrated reductions in fuel consumption. The Committee believes that the Department should make some basic changes in the PFS formula to compensate PHAs on a basis which gives greater emphasis to energy conservation. The Committee will monitor carefully the Department's implementation of this appropriation language and the directives contained in this report."

Each specific point raised in the question and our response follow:

Question. Private market housing in general cannot be compared to public housing in this simplistic way, because of differences in the characteristics of the stock, such as age, physical characteristics, units sizes, condition, deterioration, etc.

Response. Although we recognize that the characteristics of private market housing may not be identical to those of the low-income public housing program, we believe them to be sufficiently similar to make a comparison valid.

Question. The data even for private market units is not reliable and readily available.

Response. The responsibility for gathering the information needed for each state has been assigned to our ten Regional Administrators. They were to compile the data by consulting with the Department of Energy, local/state energy offices, utilities companies or other sources available to them. Determinations have actually been made that Regional Administrators believe to be reasonable. In addition, since 1979 each PHA has been responsible for maintaining the data for private market units, as required by the Section 8 Existing Housing Certficate Handbook, to be used in setting utility allowances for Certificate holders.

Question. The proposal penalizes PHAs that made extra efforts to conserve energy prior to 1976, since their consumption levels will be reduced based upon 1976-81 private market trends.

Response. The base period consumption used in the analysis was for the years 1973-74-75-76 and therefore, any efforts made during this period to conserve energy has already been factored into the allowable utilities consumption level of the PHA and will not again be used to reduce consumption.

Question. HUD controls the means by which PHAs can reduce consumption namely through modernization funding, and the mandatory consumption reductions do not take modernization funding into account, except for the *additional* reductions mandated wherever "energy-related" modernization has been done.

Response. The consumption levels set as goals for PHAs have been based upon state reduction factors and Regional Administrators were authorized to reduce the state factor by the impact of utility reductions brought about through capital expenditures.

Question. For PHAs that have done better than the private market at energy conservation, their incentive to conserve further will be removed, since their consumption level is reduced to the prior year's level, not simply to the private market average.

Response. It is our position, that if the PHA has been able to achieve a consumption level lower than the private sector, then it should be expected that the PHA will continue to achieve these levels. The best incentive is a fiscal imperative.

Question. HUD has already determined what the consumption reduction is going to be, in order to meet HUD's need to reduce operating subsidy. If the Regional Office's calculations don't fit the range pre-determined by HUD Central, the assumption is that the calculations are wrong, and a minimum 5 percent reduction will be used.

Response. We have not pre-determined what the utilities reduction savings will be. The Regional Administrators determine this factor using the guidelines issued by Headquarters. We believe it reasonable to set a minimum goal of five percent to provide an incentive for all PHAs to share in this effort to reduce energy consumption.

Question. The adjustment factor will be applied to new projects as well as to old ones. It is illogical to apply consumption reductions based on the period 1976–81 to projects that may be only a few years old. In addition, newer projects were probably built to more energy-conserving standards, and therefore don't have as much potential for further energy savings as older projects.

Response. Under the PFS instructions, the AUCLs of new projects were to be established using the consumption experience of a project with comparable types of utilities and which was likely to have comparable per unit levels of consumption based on the physical characteristics of the buildings. Such experience had to have occurred during the Fixed Base Period of the comparable project which would have been during 1973–74–75–76. Since the AUCLs of new projects were set in this fashion, the procedure issued for reducing consumption is applicable to new projects.

Question. New Comprehensive Modernization (CIAP) projects have not been in place long enough to have their paybacks determined.

Response. The payback factor for modernization programs is to be computed only on the amount of funds spent. If the CIAP was recently approved and no funds have yet been spent by the PHA, there would be no consideration given in calculation of the payback percentage.

If funds were spent but sufficient experience has not been accumulated, the payback would be based upon estimates of the savings. These estimates could have been computed using cost/benefit analysis or, in some cases, manufacturers' estimates of saving to be achieved from new equipment installed.

Question. The proposed procedures will effectively eliminate all incentives for energy conservation.

Response. We anticipate that the current adjustment of 50–50 will be applied against the revised AUCLs if funding to do so is available within the existing appropriation. If we are able to retain the adjustment feature of the PFS, PHAs will be able to share consumption savings and thus will have an incentive for energy conservation.

Question. The 50/50 share in energy conservation savings currently allowed to PHAs will be subject to "availability of appropriation" and will probably be entirely eliminated in fiscal year 1982. This totally eliminates all incentive to energy conservation. PHAs will be in trouble in years with cold heating seasons, and won't be able to recoup their losses in years with mild heating seasons. They wil' be increasingly squeezed.

Response. As stated above, we anticipate that adjustments will be processed if funds are available. Whether we can actually do this will not be known until later in the Federal fiscal year.

Question. Water and sewer expenditures have been inexplicably lumped together with fuel costs, and reductions have been mandated for these, too, although they have nothing to do with energy conservation.

Response. The matter of eliminating water and sewer from the procedure is under consideration by the Department.

Question. One single factor will be applied to the PHA to calculate its mandatory reduction in energy consumption, regardless of its fuel mix. If the PHA's fuel mix is not the same as the fuel mix for the private market housing in the region, there may be serious inequities in the factor applied.

Response. We recognize that there may be minor inequities in using only one state reduction factor but we considered this to be more than offset by the administrative convenience in using one factor. Furthermore, since we are establishing goals and not actually measuring finite consumption reductions, great precision is not essential.

Question. Conversion of all fuels into a BTU figure for purposes of calculating this percent reduction factor, is almost impossible to do because of the different energy efficiency factors of various fuels, especially electricity. There should at least be separate factors for each fuel type.

Response. While it is true that different fuels do indeed have different energy efficiency potential, this fact does not make it impossible to calculate a BTU figure for all fuels.

Question. Requiring the fiscal year 1981 figure to be used in all cases where it is the lowest is inequitable. It doesn't allow for Heating Degree Days. If there was a mild winter that year, PHAs would be unfairly held to the same level in subsequent years.

Response. The Department is issuing supplemental instructions that authorize Regional Administrators to consider an adjustment to the 1981 consumption if it is determined that consumption used for space heating or cooling is not reflective of a "normal year."

Question. The procedure results in double-counting savings that theoretically are produced by modernization expenditures.

Response. As stated before, Regional Administrators were authorized to eliminate such savings from the state reductions factors. Thus, when a payback percentage was computed for each PHA that had actually experienced energy savings because of its own modernization program, this did not represent any duplication.

Question 29. Mr. Secretary, would you provide the Subcommittee with a technical and legal analysis of the various single-family housing stimulus programs that have been introduced in Congress? There is a proposal in H.R. 5731, as well as other proposals that have been introduced by Senators Lugar and Jackson, and Congressmen Patterson and AuCoin.

Answer. An analysis of the various housing stimulus proposals has not been completed. In general, the Administration opposes narrow purpose legislation which authorizes expenditures of significant amounts of Federal revenues and adversely affects the economy by adding to the budget deficit. Lower interest rates provide the best approach to stimulate greater housing production. Programs that add to the budget deficit do not promote lower interest rates.

The Department is implementing a number of recommendations of the Cabinet level working group on Housing Policy which are designed to stimulate the housing market without adding to the budget deficit. Mortgage fund availability will be increased by liberalizing regulations covering mortgage revenue bonds and private pension funds. The Department of Labor has agreed to remove restrictions under the Employment Retirement Security Act to make it easier for pension funds to invest in mortgages. New relaxed guidelines will be used to determine a family's eligibility for the FHA mortgage insurance program. Additionally, the Department is offering (and is seeking legislation to expand its authority to offer) alternative mortgage instruments to meet today's mortgage market conditions.

Questions Submitted by Chairman Gonzalez Regarding Section 108 Loan Guarantees

Question 1. Mr. Secretary, we understand that one of the reasons the Department and the Administration oppose further Section 108 loan guarantees is the use of the Federal Financing Bank to purchase the notes from local government. Is the use of

the FFB a statutory or a regulatory requirement? If it is a regulatory requirement, why doesn't the Department simply alter its regulations to eliminate the FFB role?

Answer. The Department does not oppose the use of the FFB with respect to Section 108. The use of the FFB as the sole lender under Section 108 is a regulatory requirement, not statutory.

We believe the use of the FFB facilitates the administration of the program and results in a substantially lower cost of the borrower. From the standpoint of debt management by the U.S. Government, channeling these loans through the FFB provides improved coordination and control of borrowing.

However, it is the Administration's position that, in order to reduce the pressure of Federally guaranteed borrowing—regardless of whether or not the FFB is involved—the Section 108 loan Guarantee Program should be terminated in fiscal year 1983.

This is being effected in a graduated fashion by our proposal for a level of commitment of only $125 million in fiscal year 1982, a reduction of $100 million from the amount authorized.

Question 2. Has the Department investigated what impact freeing the Section 108 loan program from the FFB would have on its operation?

Answer. We have investigated this matter and concluded that disassociation with the FFB would increase the burden on the Department and on the Cities of administering this program. Under the present arrangement with the FFB, the administrative burden is minimized.

Question 3. Does the Department believe that private lenders would be willing to buy these notes directly from local governments if they were covered by the Section 108 guarantee?

Answer. For an interest rate in excess of that charged by the FFB, local governments could probably sell Section 108 guaranteed obligations to private investors.

Question 4. What is the current cost to the Federal government of issuing these notes? In other words, what is the average interest rate on the outstanding loans, and what servicing fee, if any, does the FFB charge the local governments making the loans?

Answer. There is no cost to the Federal government. The cost (i.e., the interest rate) to the borrower is equal to the rate the Treasury would pay on its debt with terms comparable to the guaranteed obligations, plus one-eighth of one percent. The one-eighth percent allows the FFB to accumulate reasonable contingency reserves and protect the Bank against risk of borrowing. A separate rate is established for each loan, depending upon the rates on Treasury obligations at the time the loan is guaranteed. We do not have information available as to the average interest rate on outstanding loans. Neither the FFB nor the Department charges the borrower a servicing fee.

Question 5. Does the Department know whether eliminating the FFB from this program would increase, decrease, or have no effect on the overall cost of the program to local governments? In other words, would individual placements of these notes entail a higher servicing charge from private sector underwriters?

Answer. Eliminating the FFB would increase the cost to local governments. Based on our discussions with private investors, local governments could expect interest rates on privately purchased obligations to be 100-300 basis points higher than FFB rates. Local governments could also expect to pay issuance costs (e.g., underwriting and legal fees) on privately purchased obligations, whereas they pay none on FFB purchases. These issuance costs could add 500 basis points to their borrowing costs.

Question 6. Has the Department investigated whether or not private underwriters would be willing to underwrite these obligations without the FFB, given the highly uncertain nature of the security offered, considering the Administration's proposals to fold CDBG into some larger "New Federalism" trust fund?

Answer. We have not discussed with private investors their willingness to purchase guaranteed obligations since the announcement of the Administration's proposals. Nevertheless, we think it likely that these obligations could be marketed to private investors, for a price, since the Department has borrowing authority with the Treasury. This borrowing authority could be utilized if the security (e.g., pledged grants) proved to be insufficient. However, investors would reflect greater uncertainty by charging higher interest rates and issuance fees.

Chairman GONZALEZ. H.R. 5731 is exactly what the President was demanding. He was asking those who were critical to put up or shut up, to offer alternatives. This is exactly what H.R. 5731 is. We are putting up, and you don't even refer to it. You have based most

of your testimony on administration programs that weren't revealed until yesterday.

So, in light of the futility of raising any issues concerning the main vehicle for these hearings, I will move on.

Mr. McKinney?

Mr. McKINNEY. Mr. Secretary, I would like to roam through a couple of my concerns and see if I can elicit any comment.

There is a great deal of talk and suggested use of "voucher" systems. I wondered if anyone at HUD has looked carefully at the fact that presently in HHS we have one of the largest housing voucher systems in the world through supplemental rental payments.

I wondered if anyone has looked at that particular process?

Secretary PIERCE. Yes, I am sure that people in our Policy and Development Research Office have done that.

Mr. McKINNEY. I am having a terrible problem in this town over turf. HUD and HHS are both in the housing business and neither one of them will meet.

What I have is HUD paying too much for section 8, and I totally agree with you on section 8 new construction, which I am sure comes as a surprise to you. I have HUD paying outrageous rental payments up here for section 8 new construction which, in effect, is being forced up by HHS paying outrageous rental amounts on the bottom subsiding slum housing.

I can't figure out why I can't get HHS and HUD to get together and have HUD put a little bit into rehabilitation and have HHS say that they will only give rental payments to rehabilitated or decent housing.

Right now the U.S. Government, for supplemental income level rental, has no housing qualifications, no anything. They say let the city do it.

Secretary PIERCE. That is not true. We inspect.

Mr. McKINNEY. You inspect?

Secretary PIERCE. Yes, and we will inspect——

Mr. McKINNEY. I am sorry to hear that.

Secretary PIERCE. The premises rented by people using the so-called vouchers.

Mr. McKINNEY. You will inspect the people using your vouchers?

Secretary PIERCE. We will.

Mr. McKINNEY. No one is checking the dwellings of people getting HHS assistance at all. What we are doing is while you are trying to create housing, HHS is destroying housing. What happens is that the landlord in the city of Bridgeport realizes that he doesn't have to do anything to the building, that he can collect the rent—after all, Uncle Sam is paying it—if he beats up on the tenants enough, because it does go directly to them.

He depreciates the building over a period of time. It is not much good anyway. Everyone finally leaves and then all of a sudden you look up with great shock to see red flames shooting out of the windows.

It seems to me that if, in fact, you believe with your new rehab program what you wanted to initiate is the same as my proposal, that the most housing can be achieved by saving at the bottom, so that we don't have this tremendous falloff in units, I wish that HUD would sit down with one of the largest rentpayers in the

United States, Health and Human Services, and come to some sort of agreement as to how we can save the bottom tier of housing in this country.

Mr. Secretary, I would suggest to you that if there is anything that you and I try to do, that it will never be done until this is done. While we have to lift off the pressure on the top, we have got to save on the bottom.

We are never going to save on the bottom as long as we have this loose thing on the deck called supplemental income, which I think it is about $8 to $9 billion of the taxpayer's dollars going toward the destruction rather than the building of housing.

That may be too dramatic a statement, but I can take you for a walk through some of my cities and show you rather graphically what is happening and why. I just think that if you put our cards into a voucher system to hope that it will work without looking at the disaster of the voucher system we have now, that would be a terrible mistake.

I would agree with you that we committed an unpardonable sin on this committee, for this country, when this committee passed section 8 as it now exists. We have built a monstrous financial iceberg, only the top of which is available to the sight and all of the rest of it sitting under the water, waiting to sink the United States of America.

I appreciate you listening to me, but I will smile with great joy if I can ever see HHS and HUD sit down and solve the problem of who is paying the rent and how and what we are going to do about it.

Chairman GONZALEZ. I know you didn't get any cheers from the cheering spot this time.

Mr. St Germain?

Mr. ST GERMAIN. Just one brief question, Mr. Secretary.

I wonder what the policy of HUD is at this point in time as to the question of State housing and finance agencies to reassign section 8 contract authority for projects that have no hope of going into construction, to alternative projects the State could proceed with as soon as the allocation is approved.

I understand there is such a request in the State of Vermont, pending January 7, to be specific, and if the decision is not made pretty soon, it might result in projects being lost due to expiring options on land.

Does your Department have a policy on this, Mr. Secretary?

Secretary PIERCE. If I understand you correctly, you are saying that if one State is unable to carry out some project——

Mr. ST GERMAIN. This is within the State of Vermont, believe it or not.

Secretary PIERCE. They are unable to do one project and they want to shift it to another?

Mr. ST GERMAIN. They have to shift the contract authori
one project where they can't proceed to another.

Secretary PIERCE. Does that involve shifting the pr
city to another city or another area?

Mr. ST GERMAIN. I never thought Vermont was th

Secretary PIERCE. Well, we have a policy, everythi
with Vermont.

Mr. St Germain. The point, Mr. Secretary, is that the State housing finance agency in Vermont and HUD granted a contract. That particular developer did not proceed. They have another site with another developer, ready, willing and able to proceed. The problem is that unless they proceed in the near future, unless they get the thing resolved, the option they have on the land will be gone and——

Secretary Pierce. We do not automatically shift from city to city or place to place. It would depend upon the facts and circumstances of each individual case.

Mr. St Germain. I guess to simplify the question, does HUD have a policy—if the circumstances are proper, do you allow the shifting of a contract?

Secretary Pierce. It could be done, yes. It would depend on the circumstances.

Mr. St Germain. If it meets all of the other requirements, naturally. So perhaps you should take a look at this Vermont requirement because we don't have a member here from Vermont.

Secretary Pierce. Have you been in communication with our office about it?

Mr. St Germain. I would have to check with staff, but I will have them follow up. We have no members from Vermont on the committee.

Secretary Pierce. We will look at it very quickly and certainly act within the time that they have to get this done.

Mr. St Germain. Again, the answer to the overall question to getting Vermont, whatever State, X, Y or Z, given proper circumstances and that the requirements are met, HUD does not have a policy flat out against the transfer?

Secretary Pierce. It would depend on the circumstances, how much money we have put into it and so on. If we have put a substantial amount of money in it, we will not start another one.

Mr. St Germain. That wouldn't be feasible?

Secretary Pierce. It wouldn't be wise.

Mr. St Germain. Thank you, Mr. Secretary.

Chairman Gonzalez. Mr. Wortley?

Mr. Wortley. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. I wonder if you would take a moment or two to give us your rationale for the recommendation that section 8 of RESPA be repealed.

Secretary Pierce. All right. There has been a movement for some time to repeal RESPA. As a matter of fact, it started during the Carter administration. There was a very expensive study done by Peat, Marwick & Mitchell. It was done between 1978 and 1980.

That study pretty much concluded that we should do away with RESPA, and that for various reasons it wasn't effective. Our research people reviewed it and were in accord generally with the conclusions reached by Peat, Marwick & Mitchell.

The same conclusion was reached by the people in our Housing Office. As a result, we decided that all of RESPA, with the exception of the disclosure provisions, should be repealed, and we have taken steps to do that.

There is one portion of the legislation a lot of people get involved with; that is, the portion relating to "controlled businesses". This is

basically a fight between independent land title companies and the S. & L.'s which have bought into title companies.

What the S. & L.'s do is to send people, who are going to purchase land, to title companies the S. & L.'s have an interest in. They may have one share or more of stock in the company, but if they have as little as one share, under the present rules, they couldn't send a person to that particular title company because of their interest in that company, and referring business to such a company is prohibited by the "controlled business" provisions.

Now we think that is rather ridiculous because searching a title is something that people do properly. It would not pay a title company or the S. & L. that had an interest in it to intentionally give out erroneous information about land titles. Land titles are too easily checked, and lawsuits involving erroneous land titles too easily proved for the S. & L. or title company to risk intentionally falsifying this information.

It does do a very important thing from our point of view. It is starting to get more competition among the title companies because with S. & L.'s and others buying into new title companies, there will be more competition in the title insurance business.

Unfortunately, this "controlled business" idea has been referred to as a "kickback," but we don't view the two as synonymous.

Mr. WYLIE. Would the gentleman yield?

In that connection—I am sorry I had to leave for an emergency situation for just a minute—I understand that Mr. Wortley has asked you to explain how this came about. I would just like to read a statement from the President's address on this.

He says, "Now, fourth, we are taking action to remove restrictions on controlled businesses. Today, real estate brokers, among others, are limited in ways that they can provide services to the home buyers. As a result of our action, real estate firms will be free to establish subsidiaries to provide additional services, like title insurance, which are necessary to complete the purchase of a home."

I don't think that rises to a kickback any more than if the title insurance company provided another service.

Secretary PIERCE. We have no disagreement with that. In fact, as I said—I don't know whether you were here at the time—there has been a very, very thorough study done about this. Actually, the study was started under the Carter administration and completed, in fact, under the Carter administration, which comes up with these conclusions. It is one of the areas where we agree with the Carter administration.

We have gone along pretty much with the general conclusions of that study.

Mr. WYLIE. Title agents frequently operate through escrow agents, I know, because I did some of this legal business myself.

Thank you for yielding.

Mr. WORTLEY. If I could come up with one followup section, Mr. Secretary. The other day the President spoke before the National Association of Realtors, and he supported the concept of mortgage revenue bonds. Recently Congressmen Downey and Duncan have introduced some legislation along this line designed to streamline this concept.

Does the administration have a position on mortgage revenue bonds? Do you think they would be helpful? Some maintain—oh, excuse me, Mr. Wylie wanted to ask this—that forecasts are that about a quarter of a million Americans would be eligible for new homes.

Secretary PIERCE. Is this the Durenberger bill?

Mr. WORTLEY. No, this is the Wylie bill. It is basically the same.

Secretary PIERCE. As far as the administration is concerned, we go along with the Durenberger bill, but in the meantime, what we are trying to do is get some action. We can do a certain amount of this by regulation.

We are working with the Treasury Department to improve the arbitrage situation and to expand the area that the bonds will cover. By doing that, we can see great help to people in the real estate business, and home building, too.

So, we are going ahead with our regulatory changes, but certainly the Durenberger bill, the Wylie bill——

Mr. WORTLEY. We call it the Wylie bill over here.

Secretary PIERCE [continuing]. If that passed, we would then adjust our regulations accordingly. We have to move. This is something we want to move on—you see, the building season is starting. We feel as though we have to do some things to help the housing industry at this time.

We are moving. We don't know how long it will take to get that bill passed, but we can move with regulations much faster. That is what we are doing.

Mr. WORTLEY. We need some action now.

Thank you.

Chairman GONZALEZ. The gentleman's time has expired.

Mr. Mitchell?

Mr. MITCHELL. Thank you very much, Mr. Chairman.

It is good to see you, Mr. Secretary.

I think I generally understand where the administration is coming from in terms of housing. As is true and has been true with most of the witnesses, I am always concerned about not fully understanding a philosophical-political position that has been taken.

In order to try to clear that just a little bit, I want to quote from the statement from the fiscal year 1983 "Budget of Major Needs and Budget Details." This is with reference to public housing.

The statement says:

In addition to being very expensive to construct and maintain public housing, it has in the past resulted in excessive concentrations of low-income households in particular neighborhoods. Adverse social society effects have risen where concentrations have occurred. For these reasons, the Administration is proposing no additional public housing units be funded.

That statement, taken on its face, suggests to me that those who live in the white suburbs, raised glasses of frosted chablis, saying, "Our enclaves are safe because of the position." I think that statement reeks of racism and classism.

I know your record. Is it possible that this is one of the hidden agenda items between the idea of cutting out public housing?

Secretary PIERCE. No, not at all. From my point of view, and what I believe in, if we have any further building of public housing—and I think we have to do a lot with what we have got be-

cause a lot of it is falling apart—but if we have further public housing, I would like to see public housing dispersed in smaller buildings throughout neighborhoods all over a city.

Mr. MITCHELL. Mr. Secretary, that flies right in the face of what this statement says.

Secretary PIERCE. I don't care what that statement says.

Mr. MITCHELL. It is an official document from Dave Stockman.

Secretary PIERCE. I don't care what that says. I tell you what I believe, what I preach to my Department and what I intend to do if we have the money, and we are going to go ahead with building public housing.

I want to see public housing spread all over a city in small units so that we don't have these great big——

Mr. MITCHELL. Cities, not suburbs?

Secretary PIERCE. Cities, suburbs, towns, counties, it doesn't matter. I would like to see it put in various places in relatively small numbers. I think that spread is a good thing to do from a social point of view.

Mr. MITCHELL. I thank you for your response. I would insist that the statement taken in the context of diminished civil rights activities, attacks on civil rights and so forth, that this administration has pursued, is really a clear signal.

Now, you are proposing some rescissions which I think are terrible. Obviously the rescissions will fail to meet housing needs, make it more difficult for many people, but, in addition to that, it seems to me that these rescissions that you are proposing in budget authority and contract authority will simply alienate builders and developers.

Many of them will take the position that one developer took, who said:

> Never again will I try to do business with the Federal Government. It doesn't keep its word. I have invested millions of dollars, and these rescissions are going to be arbitrarily imposed.

Isn't there some danger that you are really, by forcing or attempting to force these rescissions, hurting the private sector that is so beloved by this administration?

Secretary PIERCE. Well, we don't think so because we think that most of the rescissions involved there do not have that kind of an impact. It means that we are not going ahead with a lot of the building that was proposed earlier.

The reason underneath all of this as to why we are not is we are trying to slow down Government spending, and we believe that the slowing down of Government spending is very important to ultimately turning this economy around and getting it into a position where it will be beneficial to all people—the builders, the poor, the rich and everybody else.

Our economy is in very poor condition, and we have to do something very basic to turn it around, and a reduction of Government expenditures is a very important part of that effort.

Mr. MITCHELL. I understand your philosophy. It just seems to me that when programs are proposed, they are proposed with the good faith of the Government behind them. When developers and builders see that those programs are proposed and start expendi tl r

money on those programs, you really do some damage to the idea that full credibility can be placed on the Government.

Has my time expired?

Chairman GONZALEZ. Yes.

Mr. MITCHELL. Can I have time for one more quick statement? You mentioned the urban enterprise on the bill. That is not an urban policy bill, in my opinion. I would hope that you agree with me. It might be a piece of one, but essentially it is a tax bill. Essentially it is a tax bill for business, which I think makes good sense.

I am concerned about the notion that you mentioned in your testimony, that this is an urban policy. It really isn't. Urban policy needs an infrastructure to go into those urban zones, including housing and education and everything else.

I don't think people should be fooled into believing that the urban enterprise zone is an urban policy bill. It is not. It is essentially a tax bill.

Thank you very much, Mr. Chairman.

Secretary PIERCE. May I just say one thing?

Mr. MITCHELL. I am sorry?

Secretary PIERCE. I don't view it as simply a tax bill. Another very important part of it is to remove regulatory constraints on Federal, State and local levels. In addition to that, State and local governments can use discretionary funds or grant money directly to businesses for a variety of things in these zones.

This is not an effort solely by the Federal Government. This is a combined effort of the Federal, State, and local governments. I certainly do not see it as a tax bill because a part of it is tax, a part of it is regulatory, a part of it is maybe grants or discretionary funds, and a part of it is cooperation by the community-based organizations, business, charitable, and otherwise.

So, this is a much bigger bill than just a tax bill, and we will see how well it comes out.

Mr. MITCHELL. I will thank you for your statement. I amend my description of the bill so it is known as a regulation, reduction tax bill.

Secretary PIERCE. You didn't get it all yet, but that is all right.

Mr. MITCHELL. That is all that is there, believe me. That is all that is there.

Secretary PIERCE. That is from the Federal point of view, but let's not argue.

Chairman GONZALEZ. Mr. Carman?

Mr. CARMAN. Thank you, Mr. Chairman.

Mr. Secretary, I would like to personally thank you for your presentation this morning. I would also like to thank you for your commitment to housing and the very, very difficult problems that certainly your Department has found itself dealing with sort of since the administration has begun.

You have had very, very difficult problems. I think your whole Department is struggling to come to creative solutions to many of the difficulties we find in the housing industry.

I would also like to publicly thank you for offering to meet with different representatives of the industry on all levels, personally, and your cooperation in that effort is most appreciated.

I am concerned, as an individual who has not had a little experience in the lending field. I am a lawyer, as I know you are also a lawyer. I am concerned about the problem I perceive as being a potential conflict of interest.

If we have lending institutions of any sort whatsoever in a position where they will be, frankly, taking care of title insurance on their own loan portfolios, I can envision, for example, where an institution, whether it is a savings and loan association, a savings bank or commercial bank or anybody else, might be in a situation where it would have as many as $10 to $20 billion worth of loans, which have been insured by its own title company.

Having been involved in various commercial transactions myself over the years, I could envision where management in a given situation might say to its employee who was running its own abstract company or title company, we really have a big deal going on here and we are very concerned about the points and the yields we are going to make on building loans or on condominium development. We really are not so uptight about these sophisticated problems of access, whether or not utilities can be brought in or out, reversionary interests, easement problems, and so forth that people might be concerned with.

As a result of that, we might end up having the loans very much in jeopardy. That is one part of it.

There is another aspect of this that I think would affect the overall housing industry. It is going to be necessary, I believe, for institutions to be able to buy and sell mortgages across the country. That is why we have FHLMC paper at this point, it seems to me.

If I, as a lawyer, or a specific lawyer is examining the mortgage portfolio or portions of it that it is going to be purchasing on behalf of the given institution, I am going to want to know that the title policy backing that particular mortgage or series of mortgages is going to be sound.

I am very concerned because we know full well that the supervisory authorities in several States are different in how they handle the supervision of mortgage title insurance policies.

So, for example, if I happen to be in a less sophisticated state, I could see where I could have the Charlie & Pete Abstract Co. doing the title search in regard to a number of different mortgages, and I am going to be afraid to let my institution, if I am representing an institution, buy those mortgages.

Clearly if they are backed up by the FHA we all know it is the best of all possible worlds because the Federal Government is there. We can kind of whitewash it and put the thing there. Even there, anybody who was responsible is going to be looking at those title policies very carefully, number one, knowing what the backup is on them and whether or not they are for real.

I wonder how, frankly, you propose or how the administration proposes, if you know, at this point, or if you want to comment on that, how that conflict of interest problem is going to be eradicated if everybody is involved in this particular part of it?

You understand the scenario of what I am raising with you, don't you?

Secretary PIERCE. I understand it, but I don't see it as an important conflict of interest problem as you do. As a matter of fact, if

we only have, say, one title company and that title company has no competition because the only party that could start a title company in that locality is a savings and loan or savings bank, what you have is one company that could do all kinds of things, possibly some very harmful or illegal things, such as setting its prices too high, because of the lack of competition.

Beyond that—let me finish, please—it is hard for me to see, from a practical point of view, a title company taking any kind of risk in not giving a proper title because the money damages it could be sued for would simply not be worth it.

There are other State and Federal laws besides the one we were just talking about which could come into play. So, I just can't see quite the problem that you see with it. As a matter of fact, without the additional competition, I can see everything that you are mentioning happening with a single title company.

Mr. CARMAN. I am not concerned at all about not having competition out three. But I have been in this spot, as indeed most lawyers who are practicing in this field have been in this spot. We have listened to people from different management portions of the industry come through and say, hey look, we have got to get something through.

This is a very big deal. All of us who have been in this field understand this particular problem because we have been living with it, at least I have been for 20 years. I know other members of the bar who also had this particular problem.

I go one step further. We all know it exists also in the field of appraisal. It is not as heavy in the field of appraisal as it is in the title insurance problem because most people don't really understand, in my humble opinion, in lay terms, the significance of the difficulties that sometimes exists here.

Having supervised the purchase of mortgages, frankly, in a number of different localities, I recognize fully not only how they affect the people here—I say here, affect people on Long Island, certainly in New York State—but also affect people in other parts of the country.

I think it is a very important matter because I think ultimately we could mess up an opportunity of institutions in one part of the country buying mortgages in another part of the country.

As a result of that, it occurs to me—while I am wide open for competition and not interested in having anything rigged or open, and I am sure you are not, either—I am very concerned about what the overall effect of that could be on the housing industry as a whole. Goodness knows we don't have to have any more roadblocks put into the way of the housing industry.

Secretary PIERCE. According to the studies that we have, I can't see any of that, but I am interested and I will listen.

Mr. CARMAN. I appreciate that very much. I have no further questions.

Chairman GONZALEZ. Thank you, Mr. Carman.

Mr. LaFalce?

Mr. LAFALCE. Thank you, Mr. Chairman.

Mr. Secretary, I just would like to see where you are coming from in attitude. Do you think that over the past decade or two, investment that has taken place in America has been slanted too

much toward housing and not enough toward other areas and that that ought to be adjusted?

Secretary PIERCE. No. When you ask me my attitude, I don't think so, but I know a lot of other people who do. They think more money should actually go into industry, that we are losing out terribly in industry and that that is having a terrible impact on the economic strength of this Nation.

Now, there are those who say that. I don't say I go that way.

Mr. LAFALCE. You have told me what you don't say and what they say. Would you tell me what you say, as Secretary of Housing?

Secretary PIERCE. As Secretary of Housing, I think on the whole in this country housing has done very well and gotten its share of investments. We are a group of people who believe in housing. The American dream has been homeownership. Maybe people even put too much of their money into housing because that is the way we think and believe. It is traditional with this country.

So far as I am concerned, on the whole, if I look over the history of this country, housing has done very well; not right now, but it has over the history of this country.

Mr. LAFALCE. Too well?

Secretary PIERCE. No.

Mr. LAFALCE. OK. I suspect that the attitude that housing has done too well may be the prevalent attitude of this administration. They may be going along with not the recession that the housing industry is in, but the depression that the housing industry is in, as one means of adjusting for their perception of the imbalance in investment priorities.

Secretary PIERCE. I can tell you from the President's point of view that is not so.

Mr. LAFALCE. Then what are we going to do about the depression? I use that word advisedly. We have a recession in the country, but in the housing industry it is a real depression.

What are we going to do about it, just sit back and wait until the interest rates recover under the overall economic recovery plan of 1981, or should we have a special program, such as that which Senator Jake Garn, Senator Lugar, and so forth, and other strong Republicans have proposed?

Secretary PIERCE. We will do what we can on an administrative and regulatory level to help. There will not be any support for big bailout legislation.

Mr. LAFALCE. You can't use bailout if we can't use kickback.

Secretary PIERCE. Highly subsidized housing legislation. There will not be great support for that because we do not feel the President's economic program has had an adequate time to run. We have to see it go for a while, and we believe in it and we believe also if you start with a program for housing you have to have one for steel, you have to have one for automobiles, and I could go on and on and on because there are so many industries at this time that are not doing so well.

Mr. LAFALCE. So I take it the administration says let's not do anything for anybody?

Secretary PIERCE. We are doing something. We do h ve a plan. We do have a program. We are talking about slowing d n, right

this minute, slowing down the cost of Government expenditures. All of that is part of the program.

Mr. LaFalce. Let's talk about expenditures. You said you are against subsidies. You are certainly eliminating the direct subsidies, but you are increasing other kinds of subsidies, a tax subsidy via your enterprise zone bill. That includes rural areas now, doesn't it?

Secretary Pierce. Yes.

Mr. LaFalce. So it is no longer an urban enterprise zone proposal, it is an American enterprise zone bill?

Secretary Pierce. It has always been called an enterprise zone, not an urban enterprise zone.

Mr. LaFalce. I don't think that is correct.

Secretary Pierce. That is what we always called it, and that is how we sent up our legislation.

Mr. LaFalce. You didn't say we have always called it. You said it before. I think you should stand corrected on that. A great many others have——

Secretary Pierce. I don't accept the correction, but that is OK.

Mr. LaFalce. You can correct it; nobody else can. What I would like to get at is what is the difference between a tax subsidy, which you are favoring, and other types of subsidies which you are not favoring? What is so special about a tax subsidy?

Secretary Pierce. When you say there are subsidies, there are subsidies right now in our program that we are handing to you. It is a question of where you stop, how much it is, under what circumstances. It is that sort of thing.

There is no general overall rule that there shouldn't be any kind of subsidy.

Mr. LaFalce. Well, you have come up with this program, this enterprise zone act or tax subsidies, for 25 cities in America. Now I remember when the Department of Housing and Urban Development just a few years back got together with EDA, SBA, and they came up with a program called the neighborhood business revitalization program, the NBR program.

A memorandum of agreement contract was signed between EDA and SBA. They would target special assistance to 25 cities, communities. What is the status of that program, Mr. Secretary?

Secretary Pierce. We don't have a neighborhood program?

Mr. LaFalce. We don't have an NBR program any longer, under Assistant Secretary Bollinger.

Secretary Pierce. NBR?

Mr. LaFalce. Neighborhood business revitalization.

Secretary Pierce. I thought you were talking about a neighborhood program—I think we have that kind.

Mr. LaFalce. What is so good about the program that you have that shouldn't be expanded and, if not, shouldn't we eliminate it? Why should we come up with this enterprise zone program instead of or in placement of or in addition to an existing NBR program?

Secretary Pierce. Let me just check and see how much we have done on this.

[Discussion off the record.]

Secretary Pierce. He says you are talking about a demonstration program, run by SBA.

Mr. LaFalce. It has been going on for several years.

Secretary Pierce. Enterprise zones and this particular program are two different things.

Mr. LaFalce. My time is expired, as always happens.

Chairman Gonzalez. Mr. Wylie?

Mr. Wylie. Thank you, Mr. Chairman.

It seemed from the last colloquy, Mr. Secretary, that the administration's attempt to bring inflation under control, which would be doing something for everybody, is being equated with doing nothing for anybody. I submit that if we do bring inflation under control by reducing the deficit, through reducing spending in some of these programs where there has been some abuse, that will help everybody in the long run.

I think that is the quest of the administration's program. To say that nothing is being done for housing is incorrect. I was at the National Realtors Association convention the other day, and I heard the President say that changes are being undertaken regarding the mortgage revenue bond programs, to loosen the arbitrage restrictions and broaden the definition of distressed areas. Congressman Wortley referred to this a little earlier.

I might say that the Republican task force on real estate, housing and thrift institutions adopted a resolution just yesterday in which we specifically mentioned H.R. 4717, which is a bill currently in conference, and called for its being amended to facilitate the use of the mortgage revenue bond program.

We suggest it be amended further to assist the purchase of homes with a purchase price of 110 percent of the average price, that the State limitation on the amount of mortgage revenue bonds be increased to $400 million from the present $200 million unless the State has a higher limit, based on 9 percent of the average annual aggregate of mortgage originations and that in addition, the arbitrage allowance be increased from 1 percent to 1.25 percent.

Now, I think that is a positive move in the right direction to get housing going in the various States, Mr. Secretary.

I think it is an irony that Ohio is 1 of only 3 States of all of the 50 that can't take advantage of that right now because we have a constitutional amendment against tax exempt housing bonds. We are trying to correct that, too.

I applaud you for what you are doing in this regard. I signed on early on this mortgage revenue bond proposal because I did think it was a positive step to try to get some new houses going in a timely fashion.

I agree, in that respect, that we do need to get the housing industry back on its feet. It can be the force to lead us out of some of our problems, vis-a-vis unemployment and high interest rates.

But I also want to applaud you for the task force, which Mr. Hovde heads up, which is working with local communities to try to reduce regulations and redtape vis-a-vis city ordinances and that sort of thing.

I think there have been some positive signs in that regard. Those are statements on my part, which are not necessarily questions, but I wanted to follow up on the previous exchange vis-a-vis the mortgage revenue bonds.

this minute, slowing down the cost of Government expenditures. All of that is part of the program.

Mr. LAFALCE. Let's talk about expenditures. You said you are against subsidies. You are certainly eliminating the direct subsidies, but you are increasing other kinds of subsidies, a tax subsidy via your enterprise zone bill. That includes rural areas now, doesn't it?

Secretary PIERCE. Yes.

Mr. LAFALCE. So it is no longer an urban enterprise zone proposal, it is an American enterprise zone bill?

Secretary PIERCE. It has always been called an enterprise zone, not an urban enterprise zone.

Mr. LAFALCE. I don't think that is correct.

Secretary PIERCE. That is what we always called it, and that is how we sent up our legislation.

Mr. LAFALCE. You didn't say we have always called it. You said it before. I think you should stand corrected on that. A great many others have———

Secretary PIERCE. I don't accept the correction, but that is OK.

Mr. LAFALCE. You can correct it; nobody else can. What I would like to get at is what is the difference between a tax subsidy, which you are favoring, and other types of subsidies which you are not favoring? What is so special about a tax subsidy?

Secretary PIERCE. When you say there are subsidies, there are subsidies right now in our program that we are handing to you. It is a question of where you stop, how much it is, under what circumstances. It is that sort of thing.

There is no general overall rule that there shouldn't be any kind of subsidy.

Mr. LAFALCE. Well, you have come up with this program, this enterprise zone act or tax subsidies, for 25 cities in America. Now I remember when the Department of Housing and Urban Development just a few years back got together with EDA, SBA, and they came up with a program called the neighborhood business revitalization program, the NBR program.

A memorandum of agreement contract was signed between EDA and SBA. They would target special assistance to 25 cities, communities. What is the status of that program, Mr. Secretary?

Secretary PIERCE. We don't have a neighborhood program?

Mr. LAFALCE. We don't have an NBR program any longer, under Assistant Secretary Bollinger.

Secretary PIERCE. NBR?

Mr. LAFALCE. Neighborhood business revitalization.

Secretary PIERCE. I thought you were talking about a neighborhood program—I think we have that kind.

Mr. LAFALCE. What is so good about the program that you have that shouldn't be expanded and, if not, shouldn't we eliminate it? Why should we come up with this enterprise zone program instead of or in placement of or in addition to an existing NBR program?

Secretary PIERCE. Let me just check and see how much we have done on this.

[Discussion off the record.]

Secretary PIERCE. He says you are talking about a demonstration program, run by SBA.

Mr. LAFALCE. It has been going on for several years.

Secretary PIERCE. Enterprise zones and this particular program are two different things.

Mr. LAFALCE. My time is expired, as always happens.

Chairman GONZALEZ. Mr. Wylie?

Mr. WYLIE. Thank you, Mr. Chairman.

It seemed from the last colloquy, Mr. Secretary, that the administration's attempt to bring inflation under control, which would be doing something for everybody, is being equated with doing nothing for anybody. I submit that if we do bring inflation under control by reducing the deficit, through reducing spending in some of these programs where there has been some abuse, that will help everybody in the long run.

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Thank you very much for appearing here.

Secretary PIERCE. Thank you very kindly.

Chairman GONZALEZ. Mr. Lundine?

Mr. LUNDINE. Thank you, Mr. Chairman.

Mr. Secretary, I would like to ask you about the UDAG program. In the past it has been used for revolving loan funds, that is, a grant was made to a community for a specific purpose and when they loaned that money out to an industry it was repaid, it was in the grant contract that they could then lend the money out to other specific categories of industry.

Recently I understand that your Department has been notifying communities that have those kinds of agreements that they are not allowed to turn the loan programs over to new loans.

Is that a change in policy? What is intended to be done with those funds that are in effect recaptured contrary to priority contractual agreements?

Secretary PIERCE. As I understand it, you are talking about the UDAG funds?

Mr. LUNDINE. Yes.

Secretary PIERCE. The funds that are recaptured are no longer to go back into the cities. I understand they will go back into the Treasury. But let me check that to be sure.

[Discussion off the record]

Secretary PIERCE. I talked with my people and they said the money still goes back to the community, so it doesn't go into the Treasury.

Mr. LUNDINE. I appreciate that. I might add, in my view, these revolving loan funds, where appropriate, can be some of the most worthwhile and effective economic development goals for the local communities.

So, I am delighted to hear that. We have had a problem in New York, and I asked Farmers Home about it. It seems to me it is spreading nationwide, that their section 515 rural renting housing is not getting the section 8 subsidies necessary to qualify people that can afford it and therefore many units are having to be returned because they are not viable without the section 8 funds.

I realize there may have been a dispute between the administration and the Congress about a rescission, but if the rescission is not accepted, will this funding be made available for the rural rental program?

Secretary PIERCE. I would have to check that with our people who have been in touch with Agriculture.

[Discussion off the record]

Secretary PIERCE. I understand if you don't approve the rescission, 5,000 units will become available.

Mr. LUNDINE. Turning to an immediate concern I have, I guess seldom do I get to ask a Secretary a question on a matter coming up this afternoon, and I don't know how to vote on it.

Are you familiar with the Corcoran and Evans attempt to try to divert $1 billion from the Synthetic Fuel Corp. to housing and, as I understand it, generally have that go into mortgage revenue bonds?

If you are familiar with it, do you support it?

Secretary PIERCE. We have no position on that.

Mr. LUNDINE. Finally, again turning back to UDAG, is it a new policy of HUD or is there an unwritten policy that UDAG is no longer going to be used for housing?

Secretary PIERCE. The emphasis of UDAG in the future will be on industrial use and commercial use and only under certain circumstances will it be used for housing, and on those occasions will have to be involved with industrial or commercial projects.

Mr. LUNDINE. In other words, only if the housing is necessary to support an industrial or commercial——

Secretary PIERCE. It would have to be part of the package, yes.

Mr. LUNDINE. Thank you, Mr. Chairman.

Chairman GONZALEZ. Mr. Lowery?

Mr. LOWERY. Thank you, Mr. Chairman.

Mr. Secretary, we are faced with probably the worst housing crisis since World War II. Are there any words of wisdom or administration policy that you can share with us beyond the President's most recent statements?

Secretary PIERCE. I can say this: That we have a Cabinet-level task force that has been working on this. We have given to the President a number of ideas. A few of those ideas he mentioned in the speech he made recently before the National Association of Realtors. Other ideas that we have given to him he has not commented on yet, and as far as I know he has not made up his mind on them yet.

Mr. LOWERY. How much longer do you think we can continue with interest rates such as they are, in the housing industry and related financial institutions, thrifts in particular? How much longer do you think we can survive before something happens?

Secretary PIERCE. Before something happens? What happens?

Mr. LOWERY. The bottom falls out, for openers. It seems to me we made a conscious decision in administration policy that because of the deficits a certain sector of our economy is going to bear a disproportionate burden. It strikes me we have an obligation to assist over this tough period.

I think the administration's overall economic program is sound, but there is an Achille's heel in that the deficits and corresponding impact on industry, the devastating impact that has on housing in particular?

Secretary PIERCE. You have hit the nail on the head—the deficits. We have to be very careful about supporting programs that will immediately increase our deficits. We have to try to cut down the deficit, not increase it.

The increase in deficit is one of the major things that causes the interest rates to stay high. If the interest rates remain high, housing and all of the other industries in this country will have one tough time.

Mr. LOWERY. I think they already are and have for about 2½ years. The housing industry has been in a state of virtual depression, let alone recession.

Secretary PIERCE. If we increase the deficit so that interest rates go even higher, as the comedians say, you ain't seen nothing yet.

Mr. LOWERY. Is the administration taking any position on the Lugar bill? Do you expect the administration will do so?

Secretary PIERCE. The President has not, to my knowledge, taken a position on the Lugar bill as yet. We have given him our thoughts from the committee and he has not taken an official position as far as I know.

Mr. LOWERY. What are the thoughts of your task force?

Secretary PIERCE. I cannot reveal that. I will let the President do the talking.

Mr. LOWERY. Thank you, Mr. Chairman.

Chairman GONZALEZ. Mr. Garcia?

Mr. GARCIA. Thank you, Mr. Chairman.

First, it is good to see you, Mr. Secretary. I really would like to start where my colleague, Mr. Mitchell of Maryland, ended off, as it dealt with the question of enterprise zones.

As the person who has over the last 2 years been in the forefront of the enterprise zones, I just want to make it very clear and state for the record that the enterprise zones are in no way, never was meant to be or never should be interpreted to be a program that is going to replace the budget cuts and the horrendous actions taken by the Congress in 1981.

I believe the enterprise zones are important, but nobody here should leave here thinking that this is the cure-all of America's urban problems. It is really a small component.

This is a conversation that both you and I, Mr. Secretary, have had in the past. I think what has happened with the media is they have made a bigger deal out of this than it really is.

I would hope that it is successful. I hope, as we progress with the enterprise zones and take the bugs out of the enterprise zones, because there will be many suggestions, that we can purify it and really make it work.

As a military person, as one who served in Korea in 1951 and having landed at Inchon, I can tell you that the fact of the matter is, as far as I am concerned, the first wave of an amphibious attack is always the one that gets their hands on them, the second wave is still difficult, and the third wave walks in pretty easily and says gee, this was easy, landing on the beach here.

I interpret the enterprise zones to be pretty much in the same category. I believe we are going to have some serious problems trying to implement them and making sure they work. But I would share with you, Mr. Secretary, that if it works, I don't think 75 zones are going to be enough over the first 3 years. I think if it works, I think we are going to have to look at this and expand it even further so that everybody at every locality in the country gets a piece of the action.

So, I just want to say to my colleague from Maryland, it is a good idea and I hope that we can all support it, but it should not be interpreted as the end-all and cure-all for America's urban problems.

Having said that, Mr. Secretary, I would like to ask you a couple of questions, if I may. I want to talk about public housing. I don't think we have really touched on it.

It seems to me that public housing—and I represent many persons who live in public housing, if I can just read off a list of about four or five questions that I have here. First, there has been a delay in getting the money out as it pertains to 1981 supplemental budgets; second, the public housing agencies still have not received,

I understand, their 1982 operating subsidies; third, HUD is threatening to cut the operating subsidies to public housing authorities, which receive home energy assistance; fourth, HUD may be violating its regulations by holding the 1981 supplemental funds, I guess, kind of hostage until public housing authorities give up their right to utility adjustments.

There are about four questions there, and I——

Secretary PIERCE. But the theme of the whole idea is that we are holding money that the public housing authority should have. That is the thing. I understand we have gotten out a great deal of this money and that if it hasn't gotten to the authorities, I don't understand why.

Let me find out. I understand it is all out. That is my understanding. That is what we ordered. I understand that has been done.

Mr. GARCIA. Mr. Secretary, if I can just follow up, can you give us some date as to when the moneys were released? Maybe there is a problem because I get hell from the New York City Housing Authority all of the time as to what is going on.

Secretary PIERCE. On March 5, $140 million was released. On March 12 the balance was released, $1.152 billion.

Mr. GARCIA. OK. The last question I would like to ask—and I will call them as soon as I finish with you, I will call the housing authority right away—is the question of the rescissions and the question of the moneys that were appropriated for section 8 housing last year.

Now, there are several projects in my community that have been held up based upon those rescissions and based upon the action by Congress waiting to see if Congress, in fact, is going to release those moneys or if in fact we are going to take those moneys and put them back in the Treasury.

If, in fact, Congress states that those moneys must be appropriated and sent out to the localities, is HUD in a position as of this moment to release those moneys or is it OMB that releases the moneys? How does that work?

Secretary PIERCE. Well, we would be in a position to release the moneys, but depending on the circumstances we may have to have an approval by OMB. It depends on the circumstances.

Mr. GARCIA. You and I have had several conversations about several projects in my community of the South Bronx, and the biggest problem we have had is the question of the rescission and the question of what action Congress is going to take. So that even in fact if Congress says that yes, we will release the moneys, there is still a possibility——

Secretary PIERCE. Let me put it this way. If, for example, you don't act on a rescission—and there are various units that can be recaptured, it depends upon what you have—we would go ahead and we would do what Congress said in that circumstance.

It is not a matter of sending out money. It is a matter of recapturing the units and doing whatever has to be done. If it is a matter of money that has to be dispensed, we would have to do whatever the Congress said.

But sometimes, as I say, you can't make—I don't want to make a blanket statement because a particular situation may involve very

complicated circumstances. We may have to have OMB approval and there might even be a disapproval after that. The matter may eventually be taken to the President, depending upon how complicated the situation gets.

Mr. GARCIA. So there is still a gray area there?

Secretary PIERCE. There could be. I just don't know every factor and circumstance. Generally speaking, yes, we will spend the money.

Mr. GARCIA. Thank you. My time is expired.

Chairman GONZALEZ. Mr. Hoyer?

Mr. HOYER. Mr. Secretary, I share the chairman's view. We have discussed, of course, the administration's program to the extent that we know it.

I understand in response to the person across the aisle that you are not prepared to discuss the technical legal programmatic aspect of the various proposals, including H.R. 5731, but also the Lugar proposal and Patterson proposal and others dealing with the single-family, homebuilding, home buying market.

Would that be an accurate statement? It is before the President, the President is reviewing it, and you are not prepared to make a statement, for instance, with respect to the buy-down proposals both in Lugar and Patterson and other proposals before us, to stimulate the home buying and homebuilding?

Secretary PIERCE. Let me save you time. It would be my opinion—I will go out on a limb on this—that the President will not go along with the Lugar or any other deep subsidy proposal.

Mr. HOYER. Essentially on the deficit theory?

Secretary PIERCE. Well, that is one of the basic things. We want to keep that deficit down and not allow it to go up. We think that will increase interest rates.

Mr. HOYER. Let me try to be brief and to the point. I have a number of questions. I am going to ask one for Mr. D'Amours, who could not be here. He is from New Hampshire. He is very concerned about the rent supplement program. He understands that in particular projects in New Hampshire, people were notified March 26 that their rents would be increased due to the loss of rent supplement funds effective April 1.

He was able, apparently, to resolve this particular crisis so that the tenants were not facing a rent increase of 75 percent. He found that in three other projects in the State of New Hampshire they are running out of rent supplement funds on May 1. The loss of those funds will mean approximately 100 elderly and disabled tenants will face the choice of using almost all of their income for rent or face eviction.

Why has the department not amended these rent supplement contracts in a more timely manner with the necessary funds so that the tenants are not threatened with the loss of their homes or tremendous rent increases? The property owners should not be put in the position of displacing these tenants.

Secretary PIERCE. In New Hampshire?

Mr. HOYER. Yes, apparently a problem with the amended supplement.

Secretary PIERCE. I understand there is no rent supplement money. We have no money to give them at this time. We have

none. We are out of money. We do have a proposal in right now, as part of our own budget proposal, to try to help remedy that situation.

Right now, the short answer is we don't have the money.

Mr. HOYER. So to solve this problem you need an emergency supplemental of some type?

Secretary PIERCE. Well, it is in the rescission package. It is a conversion of rent supplements. It would be a favorable action. It would help.

Mr. HOYER. OK. Perhaps Mr. D'Amours will follow up on that.

Mr. Secretary, if I might, with respect to your full statement—the pages I will be referring to deal with your full statement, not the short version—with respect to the community development program, you indicate not proposing legislative amendments to the community block development grant this year.

Do you perceive proposals being made to reduce this program next year? Is something in the works?

Secretary PIERCE. I don't see whether it will be increased or decreased next year. Right now I think generally, just for budget comparative purposes, we carry it at the same figure.

Mr. HOYER. So this year implies nothing other than this year?

Secretary PIERCE. That is what it is, this year.

Mr. HOYER. With respect to the UDAG program, on page 6 of your testimony you indicate you think it is operating decently. Does that lead me to believe that you do not find any waste, fraud or mismanagement in the UDAG program?

Secretary PIERCE. There was a study made. They found certain things in it that could be improved, and they are going to be, but there was no great degree of waste, fraud or mismanagement. That is a very broad term. It didn't operate perfectly. We are trying to improve it.

Mr. HOYER. When you find the program that operates perfectly, will you identify that for all of us so we can model after it?

Second, this leads me to a question of a more general nature. Can you give me a dollar figure on the amount you, as Secretary, or a management team within your organization, have identified for waste, fraud and mismanagement that can be saved? Has that been done?

Secretary PIERCE. Waste, fraud and mismanagement, a dollar figure that can be saved?

Mr. HOYER. What I am saying is the President has been very strong——

Secretary PIERCE. We can't tell you the exact number, but we do the best we can. I don't want to guess. That is what I would be doing because it is a huge organization. I don't see how anybody could figure it out with any kind of accuracy.

If you could do that, you would know where all of the waste, fraud and mismanagement is, and you should be cleaning it up. We don't know where it all is.

Mr. HOYER. Would it be fair to say in an organization of your size it is very difficult?

Secretary PIERCE. It is a very difficult thing to estimate accurately.

Mr. HOYER. For any administration?

Secretary PIERCE. For any administration.

Mr. HOYER. Following up on the enterprise zone, on page 7 of your testimony, I am interested in the distinction you make of tax expenditure. Secretary Regan testified before our committee recently and made the same observation.

As I understand the enterprise proposal, it will cost a third of a billion dollars in revenues foregone, which is essentially a phrase you used in your statement and the euphemism is used in the——

Secretary PIERCE. Let me put it this way for you. We expect $12.4 million for each enterprise zone. You can multiply that out by 25, 50 or 75 and you can see where it is. We think that that is a figure that really doesn't show the whole thing because if these are successful at all, we will get to a point where we will get all of that money back and more besides.

We will come out a winner if these are successful, but that is the money we estimate we will lose regardless.

Mr. HOYER. Your theory is that the $310 million you are referring to will in effect be money spent that will have a greater return?

Secretary PIERCE. It won't be money spent. You see, a lot of people argue that we don't really have any outlays in this program, except for administration, because enterprise zones will be located in areas where there is little or no tax revenue anyway. The Federal Government is not getting any taxes, so why should we say it costs the Government anything. There is no outlay of money and there is no loss in tax revenue.

These are arguments of economists. You take your choice. Some people would say it costs nothing, but according to the U.S. Treasury Department, the cost is put at $12.4 million for each enterprise zone.

Mr. HOYER. I have been informed my time is expired.

Chairman GONZALEZ. Mr. Bereuter?

Mr. BEREUTER. Thank you, Mr. Chairman.

Mr. Secretary, I have had a chance to look at your comments. I am sorry I was not here for your personal delivery of them. I would like to ask first a question about the enterprise zones.

I am supporting the enterprise zone concept and work with Mr. Garcia and the chairman and others. I anticipate, as I imagine you would, complaints from some struggling businesses that are not inside zones that are designated and subject to all kinds of taxes, local, State, Federal regulation and not recipients of any special privileges.

What kind of answer are you formulating for those industries or enterprises not fortunate enough to be located in a zone eventually designated?

Secretary PIERCE. Businesses can go into those zones if they want to move into them. They can go into them. They don't have to be there at the time the zones are designated. We wouldn't expect many businesses to be in those zones at the time they are designated.

Mr. BEREUTER. Some of those businesses may have difficulty in making the switch?

Secretary PIERCE. Let me say this. We really hope that a lot of businesses do not just move from one part of town into another. We

hope that through enterprise zones new businesses will be started, and we believe that there will be a lot of relatively small businesses started in these zones. These small businesses are labor intensive and would be very helpful for the unemployment situation.

Mr. BEREUTER. Some people, some changes in these laboratories which would be created with experimentation as to whether all of these taxes and regulations are really productive and do work for the public in light of that possible opportunity to use these as laboratories to find the appropriateness of these taxes and designations, do you anticipate that, given the responsibilities for implementing an enterprise bill, that you would be able to give some attention to an evaluation—very specific attention to an evaluation of whether or not the elimination of these regulations and reduction or elimination of taxes would serve the public purpose in general?

I am asking you what you would look at for an evaluation stage, if you were given this responsibility.

Secretary PIERCE. The evaluation is whether eventually we begin to increase employment in those areas and increase the tax revenue base so that money is made by the Federal, State and local governments. If that happens, then these will have been a success.

Mr. BEREUTER. Yes, I am hoping that that is a product coming out of this that we might have a look at whether these kinds of changes might be more widely applicable across society.

Secretary PIERCE. Well, as we watch them, if they prove worthwhile, I am sure that they will be used in other localities and perhaps, Congressman, the number that we can use will be increased.

Mr. BEREUTER. Mr. Secretary, on October 20 you received a report from Mr. Robert Lloyd detailing the urgent need for full funding of the public housing operating subsidies and suggesting some possible major consequences or results of not funding those PHA's at the full level.

Now, he has a different capacity, Mr. Lloyd has a different capacity. Can you summarize what some of the most important consequences would be, in your judgment, of not fully funding the public housing operating subsidies or doing something to relieve our concerns about the suggested consequences, not only by Mr. Lloyd but by others?

Secretary PIERCE. Well, when you say fully funded, do you mean under the PFS formula to have 100 percent? Is that what you are talking about?

Mr. BEREUTER. I believe so, yes.

Secretary PIERCE. Well, we don't think it is necessary to have that kind of percentage at all. We think that there can be sufficient operations at an amount under that. We think that can work because of management improvements, energy conservation, reduced consumption due to energy saving improvements, increased financial contributions to public housing from State and local governments, certain deregulation, and increased rents paid by the tenants, as well as the elimination of negative rents.

Now, by taking all of those factors together we think it will not be necessary to have 100 percent of the PFS formula.

Mr. BEREUTER. My time is expired, but I would ask final q tion; that is, if you have arrived at a recommendati

centage of eligibility, that would be appropriated in your judgment?

Secretary PIERCE. Percentage of eligibility?

Mr. BEREUTER. If we are not talking about 100 percent, can you move it into a percentage?

Secretary PIERCE. I would say somewhere around 85 percent, but let me check it with my people.

[Discussion off the record.]

It would be about 85 percent, but with these kinds of changes we think that it would really bring it to 100 percent. That is an arguable point. But at 85 percent, you are really talking about the dollars on the PFS basis.

Mr. BEREUTER. Thank you, Mr. Chairman. I understand the current approach is listed at 82 percent. So we are close.

Chairman GONZALEZ. Thank you. We recognize Mr. Vento. It is my understanding he may wish to yield to Mr. Mitchell.

Mr. VENTO. I yield to Mr. Mitchell.

Mr. MITCHELL. I appreciate my colleague yielding, and I will be very brief. I have just one other question I wanted to put to you. In a HUD memo dated February 24, an assistant secretary made this statement: "Counting food stamps"——

Secretary PIERCE. Which one?

Mr. MITCHELL. Savas.

> Counting food stamps as income most severely affects the lowest income, those with the largest families, those who are living in areas where the value of food stamps is large relative to AFDC benefits.

Do you agree with this assessment, Mr. Secretary?

Secretary PIERCE. Yes; I would agree with that.

Mr. MITCHELL. If you do, then how in all good conscience can you propose counting the value of food stamps as a part of the income for rent collections?

Secretary PIERCE. Well, we count it because when we look at the situation as a whole we find that even counting food stamps people who live in subsidized housing are living there at a much cheaper rate than their fellow citizens who have equal income, but who do not live in subsidized housing, and including the food stamps——

Mr. MITCHELL. Mr. Secretary, the statement says that it affects the poor most. That is what it says. You said you agreed with it.

Secretary PIERCE. Absolutely. It affects the poor the most. The poorer, the more it affects them.

Mr. MITCHELL. Thank you for yielding to me, my colleague.

Mr. VENTO. Thank you for that question.

Mr. Secretary, you know we have been around the UDAG thing a little bit. As you pointed out Treasury has estimated the revenue loss of the enterprise proposal. I think they are accurate with regard to that.

UDAG usually had provided almost a six-to-one leverage. I don't know if your new study that you did indicates that or not, but I think that is generally the basis we have been operating on.

What type of leverage in an enterprise zone can you offer? If the average revenue loss is $12.4 million, is that on an annual basis or are we going to see $75 million of new leveraging with that every year? Can you respond to that or not?

Secretary PIERCE. I don't think anybody can give you an exact figure of what enterprise zones will do right now. That is why we call it an experimental program. That is why we only seek 25 in each of the first 3 years.

I don't think anybody can possibly tell you that there will be a lot of money made from enterprise zones. We believe that we will be successful.

Mr. VENTO. Therefore, couldn't we be better off, if this is the program, I guess a tax program more than an urban program—it is very hard I think to drive policy like this through, I think the targeted aspects of the UDAG program——

Secretary PIERCE. That is a matter of opinion. That is what you think. We think otherwise.

Mr. VENTO. One of the questions we raised when you were here concerned the section 202 program and the new mandates from HUD, which you didn't answer my question with regard to, which said that an operator had to offer an option whether or not food service had to go with section 202 programs.

You said you would be getting back, you would like to answer it for the record. I received no answer on it.

Secretary PIERCE. Let me find out why.

Mr. VENTO. It was raised in the hearing on section 202. I mean this is——

Secretary PIERCE. Hold it.

[Discussion off the record.]

Secretary PIERCE. I understand that the answer has been prepared and it is going through clearance. You should have it shortly.

Mr. VENTO. I didn't think it was that complicated a question, Mr. Secretary, but I do appreciate your attendance to that particular issue.

Mr. Secretary, under the section 8 neighborhood strategy area program, which began in 1979, local governments were assured that they would have a number of units.

HUD's budget proposal for 1983 and its revised 1982 budget shows no section 8 substantial rehab units have been requested. The Conference of Mayors outlined a necessity of agreement for 4,300 units in 1982 and some 1,300 units in 1983.

Were they consulted and, if not, why not? Are the mayors' figures accurate?

Secretary PIERCE. Was who consulted?

Mr. VENTO. The mayors, with regard to the change in the section 8 unit program, with regard to the neighborhood strategy area program?

Secretary PIERCE. Let me put it this way. We don't have to consult, the mayors are there talking to us all of the time. Some of them even have offices here in Washington.

Mr. VENTO. They probably need them based on the way things are changing. The fact is, Mr. Secretary, what I am asking is will we go forth with the commitment for these particular units. The mayors' figures I assume are accurate. What does HUD recommend be done with regard to these activities? If we make agreements, I think we should keep them.

Secretary PIERCE. We made an agreement with the n

Mr. VENTO. That is right. With regard to the neighborhood strategy area, we surely did. They expended a considerable amount of funds, banking on the fact that they will have those particular units, in anticipation of receiving those particular commitments.

I don't understand how now we can pull the rug out from under these communities. These, I think, are a higher level of commitment than what other section 8 units might be, Mr. Secretary.

Secretary PIERCE. As I understand it, there was no agreement.

Mr. VENTO. No legal agreement?

Secretary PIERCE. No agreement made by us. I understand there was probably some agreement made under the Carter administration and none by us.

Mr. VENTO. Have you changed the law with regard to this neighborhood strategy program? As far as I know there has been no change. Is there a commitment to the local communities with regard to this?

Secretary PIERCE. There is no law, I understand, on this.

Mr. VENTO. They have expended money in terms of anticipation of receiving those, you understand that?

Secretary PIERCE. Have they? I suppose they have.

Mr. VENTO. Mr. Secretary, the utility cost increases in terms of the public housing is very significant and yet, in the budget request for 1983, public housing has modernization funds available only to the obligated public housing units in the pipeline.

How does this proposal insure that public housing authorities who most need modernization funds will have them, as an example, for energy conservation efforts and so forth? The funds are only available for deobligating. How are those other needs going to be met?

Secretary PIERCE. We think if they will deobligate two of the units, they will get the money equivalent of one unit to use for modernization purposes.

Mr. VENTO. What if they don't have any to deobligate, Mr. Secretary?

Secretary PIERCE. There is also other money we have that can be given to those who do not have the units.

Mr. VENTO. Do you have any data, Mr. Secretary, that would support or show how the units in the public housing authority in the pipeline correspond to their modernization needs or capacity? Obviously this is a very substantial change in policy.

Secretary PIERCE. We can get you that.

Mr. VENTO. You can get that for us?

Secretary PIERCE. We will get it and put it in writing.

[The information follows:]

RESPONSE RECEIVED FROM SECRETARY PIERCE

The following table shows for the nation's 50 largest Public Housing Agencies the number of units in their preconstruction pipeline and the estimated amount of loan authority available for those units, compared to the estimated demand for modernization for each agency.

[Dollars in thousands]

Public housing agency	Number of units in precon-struction pipeline	Estimated loan authority	Modernization demand 1982-84			
			Number of units	Energy modification	Other modification[1]	Total demand
New York City	9,067	$774,548	146,543	$230,000	$200,000	$430,000
Puerto Rico	2,009	87,277	52,268		149,297	149,297
Chicago	2,227	146,149	38,943	25,000	100,000	125,000
Philadelphia	108	6,129	23,028	70,000	230,000	300,000
Baltimore	333	16,034	17,052	4,500	94,000	98,500
Atlanta			14,616	5,500	70,500	76,000
New Orleans	144	6,697	13,615	1,500	77,500	79,000
Boston	699	39,464	12,757	24,000	88,000	112,000
Newark	617	40,715	12,674	208,696	248,753	457,449
Cuyahoga (Cleveland)	270	13,983	11,503	9,000	53,230	62,230
Washington, D.C.	823	45,742	11,184	1,175	48,600	49,775
Detroit	666	36,775	10,216	18,062	100,627	118,689
Pittsburgh	273	15,036	9,816		27,595	27,595
Dade County	1,413	60,835	9,536	3,000	27,000	30,000
Los Angeles	1,183	73,827	8,213	20,000	34,000	54,000
City	250	9,297	7,602	1,118	20,865	21,983
San Antonio	100	6,432	7,080		36,000	36,000
Dallas	123	5,680	6,990	1,181	88,064	89,245
Minneapolis	25	1,434	6,851	3,000	55,000	58,000
Cincinnati	164	9,636	6,782	3,093	30,689	33,782
Memphis	632	25,995	6,749	3,000	3,670	6,670
St. Louis	637	33,789	6,741	8,180	121,675	129,855
Birmingham	110	4,791	6,702	2,753	35,856	38,609
Nashville	431	17,727	6,218	875	21,838	22,713
Louisville	150	5,250	6,063	1,200	48,885	50,085
Seattle	312	17,411	5,996	3,757	17,841	21,598
El Paso	320	14,776	5,764	365	15,026	15,391
Buffalo	510	27,721	5,027	1,000	46,000	47,000
Columbus	615	36,136	4,846		7,977	7,977
Denver			4,689		44,112	44,112
Hawaii	403	32,366	4,651	NA	NA	NA
Milwaukee	325	17,506	4,421	NA	NA	76,821
Richmond	134	5,859	4,335	5,006	23,120	28,126
Tampa	151	6,501	4,178	1,000	25,000	26,000
Dayton			4,106	1,106	6,794	7,900
St. Paul			4,094	300	7,131	7,431
Norfolk			3,975	4,449	9,325	13,774
Akron	175	9,063	3,968	5,000	23,000	28,000
Mobile	122	5,313	3,872	9,000	18,000	27,000
Allegheny County	292	16,082	3,821		34,250	34,250
Jersey City	168	11,085	3,706	6,046	20,778	26,824
Chattanooga			3,695	2,101	45,260	47,361
Knoxville	100	3,904	3,675	1,650	6,600	8,250
Charlotte	25	1,057	3,591	3,149	20,600	23,749
Oklahoma City	68	3,180	3,362	1,500	8,500	10,000
Total	26,174	1,691,207		690,262	2,390,958	[2] 3,158,041

[1] Other Mod includes emergency needs in fiscal year 1982 and comprehensive needs in fiscal years 1982-84.
[2] Totals for energy modernization and other modernization do not add up to grand total because for Milwaukee only a grand total was received.

Mr. VENTO. How will you propose to fund the modernization program to $1.8 billion if recaptured funds does not take place, as you anticipate? Do you have an answer to that?

Secretary PIERCE. If the recaptured funds do not take place?

Mr. VENTO. Yes; if it does not take place. If those funds don't materialize, have you got any alternative to meet these particular needs? I mean, some of us believe it will not take place.

Secretary PIERCE. No; we do not have an alternative.

Mr. VENTO. Maybe you want to expand on that answer. I see staff is talking to you.

Secretary PIERCE. Well, we have no other alternative program. There are apparently a lot of units that are old or can be deobligated that we can use if we have the authority to do so.

Mr. VENTO. I guess we are concerned about moving in that direction without the data. Of course, we are concerned about producing the amount of public housing available during times of stress.

Obviously during these times very few people can afford housing because of the rates of interest and general economy. But you know during all times, the people that use assistance housing are precluded from being able to afford housing in the country.

So we are very concerned about pulling away these programs at the expense of those that do not have adequate housing and are not likely to be able to obtain it within the context of our society.

Thank you, Mr. Chairman.

Chairman GONZALEZ. Thank you.

Mr. Secretary, I cannot allow this session to terminate without the record reflecting a very gross contradiction in the statement you made concerning the Peat, Marwick & Mitchell RESPA study.

As you know, this subcommittee had very extensive oversight hearings on RESPA. I think the record has to be clarified. As I was listening to you, I realized there was some contradiction in what you said, and I have had the legal staff doublecheck.

The Peat, Marwick & Mitchell study concluded: One, that, RESPA has resulted in some increase in the consumer shopping for settlement services, and an increased level of price competition in some markets.

Second, the study also set some conditions for changing RESPA so improvements and increases in competition could be achieved. These include requiring the special information booklet—and we expect several hours on that in the hearing—to be given to consumers by the real estate agents during the earliest stage of the home buying process and not by the lender.

Third, the study also stated, and I quote:

> Concern about the conflict of interest is justified where title search and evaluation is conducted by a title agency which is controlled by a firm that has an economic incentive to avoid discovering title relief problems. A broker who owns a title agency has a potential conflict when a sale may not be consummated and a commission lost because his title agency has uncovered a potential title defect.

I am sure this is what motivated Mr. Carman. Clearly the Peat, Marwick & Mitchell study cannot be used to justify either your recommendations regarding repeal of section 8 of RESPA or your proposal to change the interpretative rule on control businesses.

Now, it does appear to me that all controlled business arrangements are necessarily noncompetitive or free from conflicts of interest. As the hearings on control businesses in the title insurance industry last year indicated, there are significant problems connected with such arrangements in the title industry.

Accordingly, what I feel would be a responsibility on your part would be to distinguish between those ancillary settlement services that would not be appropriate or anticompetitive for brokers or lenders to provide through their subsidiaries, such as credit reports

and approvals, and those services where significant anticompetitive or conflict of interest problems might arise. I think such an approach would be far more realistic and also beneficial to the general interest.

I would like very much to know if you and the administration would be willing to work with us to devise such an approach, for we intend to resume our consideration of this matter later in the year.

Secretary PIERCE. We would certainly be happy to work with you and to try to do what is best for the general public. Also, I would like to have put into the record, so that there would be no question about the clarity of the various reports, the Peat, Marwick & Mitchell report, as well as the report of our Office of Policy Development and Research on this matter.

So, if you will let us put those in the record, we will work with your committee. Our whole objective is just like yours, to do the best we can for the general public.

Chairman GONZALEZ. In the case of the Peat, Marwick & Mitchell study, I think we did put it in the record last time, but if we did not, then without objection we will do so now, in addition to the Department's study.

Secretary PIERCE. I would like them both in the record because it is easier if somebody is reading this, they don't have to go to another report to look up what we are talking about.

Chairman GONZALEZ. I agree. If there is no objection, so ordered.

[Statement submitted by Secretary Pierce forwarding "Report to Congress on the Need for Further Legislation in the Area of Real Estate Settlements" submitted in September 1981, and Peat, Marwick, Mitchell & Co. (PMM) report dated October 1980, and April 1981. The reports are too voluminous to reprint in the hearing record, but are being kept on file for future reference in the subcommittee.]

HUD STATEMENT SUBMITTED FOR INCLUSION IN THE RECORD

Attached for the record is HUD's "Report to Congress on the Need for Further Legislation in the Area of Real Estate Settlements" submitted in September 1981. Also provided are the Peat, Marwick, Mitchell and Company (PMM) reports dated October 1980, and April 1981.

The HUD report to Congress was based not only on the PMM study, but on additional HUD analysis of the information provided by the study and years of experience administering the act. In addition, HUD consulted with representatives of the housing financial institutions and Federal Government agencies concerned with homeownership settlement practices.

It is important to emphasize that the issues associated with settlement practices are complex and the data available are subject to varying interpretations. For example, with regard to the question of conflict of interest between title insurance agencies and a broker or lender, the PMM evaluation of October 1980 concludes: "This argument (controlled business will lead to poor quality work) is not very persuasive." The Executive Summary of October 1980 calls prohibition of controlled business a "draconian solution." The April 1981 Executive Summary revision notes on the same subject: "... concern about conflict of interest is justified in situations where title search and examination is conducted by a title agent which is controlled by a firm that has an economic incentive to avoid discovering title [illegible] problems." The HUD report concludes on a controlled bu[illegible]

[illegible] the net benefits that accrue to consumers in the form of a lower [illegible] product.

Chairman GONZALEZ. Now, I think that you were under a time constraint, therefore, as far as the Chair is concerned, we are finished now. But it may be that if you have the time, Mr. Wylie, Mr. Bereuter or Mr. Vento might have a question.

Secretary PIERCE. I would appreciate it if you could put those questions in writing. I would be glad to answer them.

Chairman GONZALEZ. Mr. Bereuter?

Mr. BEREUTER. No.

Chairman GONZALEZ. Thank you again for coming.

Secretary PIERCE. Thank you, Mr. Chairman.

Chairman GONZALEZ. The subcommittee stands in recess until 2 p.m. this afternoon in this same hearing room.

[Whereupon, at 12:05 p.m. the subcommittee recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Chairman GONZALEZ. The subcommittee will please come to order, and first we will hear from our distinguished colleague from Illinois, Congressman O'Brien. Thank you very much for being with us, Congressman, you may proceed as you wish.

STATEMENT OF HON. GEORGE M. O'BRIEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. O'BRIEN. Thank you, Mr. Chairman. It is an honor to appear before your subcommittee. The saying goes that the lead dog is the one who enjoys the scenery, so I am glad I am the first one called.

I would like to offer my statement for the record and speak a cappella, so to speak. The problem that we are facing is well known to the chairman and the distinguished members of the subcommittee, which is to try and do something for our housing market, to give it a boost, get it on its feet. In my home county in the last 12 months they have had 19 homebuilding permits. You cannot support an industry and all that the industry supports in that condition.

To speak directly to the issue, you single out my bill as one that the committee and the chairman might look favorably on. Mine is not dissimilar from Mr. Emerson's. His is called the homeownership equity loan program, or HELP, and mine is called the homeowner's opportunity participation enterprise, or HOPE. It provides a 1-year-only interest or principal-reduction subsidy. We would differ because it will apply in my case to newly constructed as well as unsold homes in inventory. We are the same in that our interest subsidy would be 12 percent, a maximum of $6,000 per home, would be fully recapturable and GNMA-administered. We differ in that his would relate to a first-time home buyer, mine to any home buyer. And we differ on where the funding would come from.

I take no pride in ingenuity in looking for funding that might be available without disturbing our concerns over budget and deficit, but my bill would look into the funding that is more or less on the shelf, and not being used for public housing, and I think there is about $1.5 billion there, and I would in a sense ask that we could transfer that, have it administered by GNMA and be dealing in a ıse with old money rather than new.

I understand that there are a number of members, including yourself, Mr. Chairman, who have advocated the notion that perhaps we should appropriate outright. I am not saying whether that is or is not the way to go. I was trying to find a source of funding least disturbing to getting our house in balance. In this fashion the money would be returned upon the resale of the home and the Government would get its investment back.

Mr. Chairman, I also know that there are efforts and advances being made to enlarge the mortgage revenue bond program, and I do not consider that this is ill-advised or not. I suspect that the risk I see is that, in increasing the amount of bonds to be issued by a given State to $400 million, I believe that it might ultimately become a very serious drain on the Treasury. So I offer without guile the O'Brien program to see if we can give a substantial boost in a relatively quick period to help our ailing housing industry. I believe it is attainable, Mr. Chairman. I think it is achieveable in the view that we always have to think of compromise. We always have to think of what we can get through the Congress and persuade the President to sign. I am not satisfied that this particular program would be attractive to the administration, but it might have a better chance than some of the programs offered.

I appreciate the honor of your permitting me to testify, and would be happy to answer any questions that the Chair might wish to offer.

[The prepared statement of Representative O'Brien and the text of his bill, H.R. 5676, follow:]

The Honorable George M. O'Brien
Testimony before Subcommittee on
Housing and Community Development
on H.R. 5676, The Homeowners Opportunity
Participation Enterprise Act (HOPE)
April 1, 1982

Mr. Chairman, I appreciate having this opportunity to urge your support for my bill H.R. 5676, the Homeowners Opportunity Participation Enterprise Act. The capital letters of this bill spell HOPE, which is what I believe this proposal offers the much-depressed housing industry as well as prospective homebuyers.

The original cosponsors of this legislation are our colleagues Bill Emerson, Bill Whitehurst, Clair Burgener, Tom Evans and Gus Yatron.

We all know that lower interest rates are essential for a real revival of the housing industry. But it is critical that an emergency stimulus program be enacted on a temporary basis in order, at the very least, to keep the homebuilding industry and related businesses afloat H.R. 5676 is a vehicle to accomplish this objective.

I am attaching a summary of my proposal but would like to highlight its major provisions. My bill is similar to Bill Emerson's Homeownership Equity Loan Progam H.R. 5150, but there are some significant differences.

First, under my bill, all credit worthy persons---not just first-time homebuyers---are eligible to buy reasonable cost homes at below market interest rates. The housing demand is there. There are more than 41 million Americans who will turn 30 during the 1980's, thus creating a record demand for single family housing.

Second, H.R. 5676 would extend eligibility for this financing to all homes started within a one year period following enactment. Only homes in builders' inventories would be eligible under H.R. 5150. The need for this expansion can be very well seen in my own district. My homebuilders tell me they do not have significant numbers of houses in their inventory. They are on the verge of bankruptcy and clearly need the kind of program that would stimulate new housing starts. Selling inventories would not help my homebuilders.

Third, my HOPE bill and Bill Emerson's HELP bill do not require any new budget authority. I am proposing the reprogramming, for one year only, of $1 billion from the Department of Housing and Urban Development's Section 4(b) public housing fund. H.R. 5150 would use $500 million from the Government National Mortgage Association's special assistance fund.

Section 4 of the Housing Act of 1937, as you know, authorized the HUD Secretary to issue and have outstanding at any one time up to $1½ billion in notes and other obligations for loans to public housing agencies. This authority currently is not being used but, under my bill, could be used to provide this very much needed stimulus for the home building industry.

Frankly, I am not at all sure that Section 4 is the best funding source. I have no pride of authorship in this provision. It certainly would be all right with me if the committee should determine that another source would be preferable, such as GNMA's special assistance fund, as proposed in the Emerson bill, or possibly, as others have suggested, the money we appropriated but has not been spent for synthetic fuels development by major oil companies.

GNMA could use the $1 billion to make a $6,000 payment for a qualified home buyer to an approved financial institution. The money could be used either to reduce the home buyer's interest payments or the principal of the loan. The National Association of Home Builders has estimated that if mortgage interest rates fell to 12% or less, 7.8 million more Americans could afford to buy a new home.

There is no doubt about it--the housing industry is in its biggest crisis situation since the 1940's. It's in the pits and the effects and statistics are staggering. Housing starts last year totaled 1.1 million units compared with 2 million in 1977 and 1978. Every indication is that this year will be the lowest production year since 1946. Unemployment in the construction industry is 18.1% or 928,000 workers. And, when one considers the fact thet one out of every 8 unemployed persons is a construction worker, it follows that a housing stimulus program would help to put a great many people back to work. In my own district the overall unemployment rate is around 14 per cent.

We are now seeing how the housing industry impacts on other related industries. We have heard about the timber industry from Congressman Emerson, and just recently General Electric announced its plans for temporary layoffs affecting 9,200 workers. These employees make dishwashers, refrigerators, washers and dryers---items used in new homes.

The bottom line is that this bill could mean more jobs, bring in more revenue to the government and generate economic productivity in a stagnated economy. It also could help cut the deficit by reducing the amount we could have to pay out in unemployment compensation payments.

What we need is an accelerated program for a very short-term. If we do not do something soon--within the next few months, the homebuilding and related industries will not be around for the economic recovery.

This could be a one-time stimulus for desperately needed single-family housing. Our nation's economic history has shown us that the housing industry can lead us out of recessions, and I believe it can do so again with this program.

H.R. 5676
Congressman George M. O'Brien

Homeowners Opportunity Participation
Enterprise Act
(H.O.P.E.)

1. Program eligibility is limited to credit worthy homebuyers.

2. Eligible homes are limited to proposed newly constructed, partially constructed, and unsold residential properties (single family, condo, or co-ops) a priority is established for lower cost basic homes ranging from $50,000 to a maximum of $90,000.

3. Mortgage financing may be provided through FHA (Sec. 203(b) and (245), VA, private or conventional methods.

4. Maximum mortgate limits are the same as under the FHA Sec. 203(b) program ($67,500 to $90,000) with terms for up to 30 years and a five percent down payment requirement.

5. The interest rate for the homebuyer is established and based upon income necessary to qualify for the loan as determined by the Government National Mortgage Association (GNMA) with such fixed rate not to be lower than 12 percent.

6. The total cost of the Federal contribution for interest or principal payment reductions will be retained and recaptured for repayment to GNMA out of the proceeds of equity appreciation upon the sale disposition, or refinancing of the property.

7. GNMA will provide a one time front-end payment up to a maximum of $6,000 on behalf of a qualified homebuyer to an approved financial institution for the purpose of reducing interest or principal payments.

8. The program is of a temporary and short term nature and will expire on September 30, 1983.

9. The Federal funding of $1,000,000,000 for providing temporary loan repayment assistance to qualified homebuyers does not increase the FY 1982 Federal Budget due to the fact that such funds are provided through the reprogramming and re-use of previously authorized and appropriated HUD public housing loan fund borrowing authority, and for which use all funds will be repaid to the Federal Government.

10. GNMA will allocate funds on a fair share State or regional basis in accordance with data reflecting unsold inventory and building permits issued for newly constructed units.

11. Preference for assistance is made, but not limited, to small size homebuilders experiencing depressed operating conditions. Homes must be for permanent full time residence of the buyer.

12. An estimated 200,000 newly constructed and/or unsold inventory homes may be aided under this program during its full year of operation.

97th CONGRESS
2d Session

H. R. 5676

To authorize, on an emergency basis, the Government National Mortgage Association to provide assistance with respect to certain mortgages secured by newly constructed homes, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

MARCH 2, 1982

Mr. O'[illegible] (for himself and Mr. [illegible]) introduced the following bill; which was referred to the Committee on Banking, Finance and Urban Affairs

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A BILL

To authorize, on an emergency basis, the Government National Mortgage Association to provide assistance with respect to certain mortgages secured by newly constructed homes, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 305 of the Federal National Mortgage Association Charter Act is amended by adding the following new subsection at the end thereof:

"(l)(1) Notwithstanding any other provision of law, the Secretary of Housing and Urban Development may, after taking into account the conditions and purposes described in

subsections (a) and (b), direct the Association to implement the provisions of this subsection.

"(2) Whenever the Secretary issues a directive under paragraph (1), the Association shall, in accordance with such directive, provide financial assistance to mortgagors by—

"(A) making commitments to purchase and purchasing the mortgages of such mortgagors and servicing, selling (with or without recourse), or otherwise dealing in such mortgages; or

"(B) making payments to mortgagees, on behalf of such mortgagors, in the form of—

"(i) reductions of the principal obligations of mortgage loans made to such mortgagors; or

"(ii) prepayments of the interest which would otherwise be due with respect to such loans.

"(3) The purpose of such financial assistance shall be to reduce the mortgagor's payments for principal and interest to an amount which would be paid if the interest rate charged with respect to the mortgage were 12 percent per annum.

"(4) Such financial assistance may be made only if—

"(A) the mortgage is a first mortgage secured by a dwelling unit (including a unit in a condominium or cooperative project) designed principally as a one-family residence;

"(B) the dwelling unit described in subparagraph (A) is newly constructed and the construction began (as determined by the Association) before October 1, 1983;

"(C) such unit has not been purchased or occupied prior to the purchase assisted under this subsection;

"(D) such unit is to be occupied by the mortgagor as the mortgagor's principal place of residence;

"(E) the mortgage is insured under section 203 or 234(c) of this Act, or guaranteed under title V of the Housing Act of 1949, chapter 37 of title 38 of the United States Code, or insured by a qualified private insurer as determined by the Association;

"(F) in the case of a mortgage insured by a qualified private insurer, the mortgage meets the terms and conditions applicable to mortgages insured under section 203 or 234(c), as the case may be, of this Act with respect to the maturity term of the mortgage, amortization and down payment requirements, the requirement of an approved mortgagee, and the limitations imposed on the interest rate and the principal amount of the mortgage; and

"(G) the agreement to provide assistance meets other requirements which may be established by the Association as necessary to carry out this subsection in an efficient and effective manner.

"(5) Upon the disposition or refinancing of the property by any mortgagor assisted under this subsection or in any case in which the mortgagor ceases to occupy the property as the mortgager's principal place of residence, the Association shall provide for the recapture of an amount equal to the lesser of—

"(A) the amount of assistance received by the mortgagor as a result of this subsection; or

"(B) an amount at least equal to 50 percent of the net appreciation of the property, as determined by the Secretary.

For purposes of subparagraph (B), the term 'net appreciation of the property' means any increase in the value of the property over the original purchase price, less the reasonable costs of sale, the reasonable costs of improvements made to the property, and any increase in the mortgago balance as of the time of sale over the original mortgage balance due to the mortgage being insured pursuant to section 245. In providing for such recapture, the Association shall include incentives for the homeowner to maintain the property in a marketable condition. Notwithstanding any other provision of law, any such assistance shall constitute a debt secured by the property to the extent that the Association may provide for such recapture. The amount of any recapture made under this sub-

section may not be expended without approval in an appropriation Act.

"(6) In issuing any directive pursuant to paragraph (1), the Secretary shall provide that—

"(A) the assistance provided under this subsection is allocated among the various regions of the country on the basis of data reflecting unsold inventory of housing and building permits issued for newly constructed homes with respect to which assistance may be provided under this subsection;

"(B) the amount of assistance received by any mortgagor as a result of activities authorized by this subsection shall not exceed $6,000;

"(C) a priority is given to providing assistance with respect to mortgages secured by dwelling units which are modest in design; and

"(D) to the maximum extent feasible, a priority is given to providing assistance under this subsection which will benefit small homebuilding operations.

"(7) The authority of the Association to enter into commitments to provide assistance under this subsection shall expire at the close of fiscal year 1983.

"(8) With respect to fiscal year 1982, the Association shall provide assistance under this subsection by utilizing the amount of authority which has been provided, in Public Law

97–101, to the Secretary to carry out the low-rent public housing loan fund under section 4 of the United States Housing Act of 1937. With respect to fiscal year 1983, the Association shall provide such assistance by utilizing, to the extent approved in appropriation Acts, the authority of the Secretary to issue obligations under section 4(b) of such Act. The total amount of assistance provided with respect to both such fiscal years under this subsection may not exceed $1,000,000,000.

"(9)(A) The provisions of the constitution of any State expressly limiting the rate or amount of interest, discount points, or other charges which may be charged, taken, received, or reserved by lenders and the provisions of any State law expressly limiting the rate or amount of interest, discount points, or other charges which may be charged, taken, received, or reserved shall not apply to any mortgage which is assisted under this subsection.

"(B) The provisions of subparagraph (A) shall apply to mortgages made or executed in any State until the effective date (after the date of enactment of this section) of a provision of law of that State limiting the rate or amount of interest, discount points, or other charges on any such mortgage."

SEC. 2. Section 302(b)(1) of the Federal National Mortgage Association Charter Act is amended by inserting "or a

mortgage purchases under section 305(d)," after "of Hawaii," in clause (3) of the proviso of the first sentence.

SEC. 5. Section 4 of the United States Housing Act of 1937 is amended by adding the following new subsection at the end thereof:

"(e) No loans or commitments to make loans may be made under subsection (a) during the period beginning on the date of enactment of this subsection and ending with the close of fiscal year 1982."

Chairman GONZALEZ. Thank you very much, Congressman, and I compliment you for your concern and your specific suggestion.

These hearings on H.R. 5731 were conducted jointly with the full committee chairman's emergency bill to relieve troubled savings institutions. However, mainly, the bill that you have made some reference to in your statement is our primary concern. We feel it is the only means available for quick, concentrated attention to housing but in my book it is minimal. I would like to have pushed for a lot more, but this is what we could get a consensus on. We have been in very close contact with the Budget Committee, and we are within their limits on budgetary authority. Basically, we are providing for production, which as you know, the administration is zeroing out with very, very little exception, as in the case of the section 202 program—only after great protest on our part here for the past few weeks.

Your bill, as you envision it, has features that we have seriously considered and evaluated. I do not know, though, that it sufficiently addresses itself to the crisis that I think impels us both to get some action on this year. From the testimony we have been hearing not only during the course of these hearings, but from the comprehensive hearings held by the subcommittee last year it was clear the message we were getting from the eastern shore to California that there is a crisis, there is a bad situation.

Your section in your State is really not exceptional. So let me promise you that this subcommittee is evaluating your bill, and it may be that some of those provisions might be feasible to be incorporated in H.R. 5731. I think in markup, the majority members are not going to hesitate to do that.

In other words, we are grateful because you are presenting your bill. You have offered us an opportunity to evaluate some alternatives to some sections of our bill. The problem as I see it was very dramatically illustrated this morning with the testimony of the Secretary of HUD, and that is—and to me it is incomprehensible—an unwillingness, or what appears to be a fear of being accused of having failed in some promised programs. Or in being accused of fudging on a position taken dogmatically. I cannot understand it otherwise, because even the Secretary this morning was so contradictory, on the one hand saying in answer to specific instances in questions of some of the members, well, yes, we realize that this is a situation, we realize that what you are inferring might seem to be true, but that is not our intention. Our intention is very different.

But we are not dealing with intentions. We are dealing with conditions that confront us. And so therefore, even if we were to incorporate some parts of your bill, we would still have to contend with getting expeditious and successful consideration of other matters as included in this legislation. You referred to budget impact in our bill. I want to assure you that everything contained in the bill is strictly within the limits of the budgetary restrictions that we have been told are necessary.

I will say this, that this subcommittee is evaluating your bill and will continue to during markup, which we hope we can proceed on quickly after we come back from the Easter recess.

Mr. Lowery.

Mr. LOWERY. Thank you, Mr. Chairman.

Congressman O'Brien, it is great to have you here. I cosponsor your bill. I think it is something that offers hope to an industry that definitely needs help, so whether it is your bill or Bill Emerson's bill, I think we need to do something.

It just strikes me, and I believe the President's program, I think it is sound, but I think there is an Achilles' heel, and that is those $90 billion deficits which have a definite impact upon interest rates and the disproportionate burden that the housing industry must carry because of those high interest rates. Right now in San Diego there are some 7,000 unsold homes with untold numbers of qualified buyers, and what is stopping them from occupying those homes and getting more construction workers back to work are the interest rates. It strikes me that if we had made a conscious decision that we will have high deficits, I think we have a corresponding obligation and responsibility to those industries which are disproportionately impacted.

The housing crunch did not occur during the past few months or during this administration. Housing has been in a state of depression, not just recession, for 2½ years. I commend you for your efforts with HOPE.

I do have a specific question. Do you have any estimates as to how much time it would take to provide assistance for the homebuilding industry with the approach that you recommend?

Mr. O'BRIEN. It would be a pure guess, Bill. Are you suggesting how long it would take us to get our bill made into law?

Mr. LOWERY. No; that is like asking how many stars are in the sky. The sooner the better, admittedly, but assuming it was enacted into law, how quickly would you see some injections into the housing industry, see things implemented on the end of the line?

Mr. O'BRIEN. I would think we ought to be able to do it in 3 months, but I may be optimistic, after the matter becomes law.

Mr. LOWERY. What is your prognosis on moving ahead through this legislative maze?

Mr. O'BRIEN. Well, I think the chairman probably is a better judge of that. That would be pure speculation, but I would like to think that we could get it after the things we have currently are out of the way. Perhaps by July, and then press on to get a bill passed and into law by mid-August.

Mr. LOWERY. It strikes me that the approach that you have taken, you have shot it into new construction, to get construction workers back to work and to lead us out of the recession that housing has led us into. We have not come out of recessions until housing has led the way out. That would be a minimal expense of Federal dollars and minimal impacts on deficits, and I think is right on point. I commend you for your efforts.

Thank you, Mr. Chairman.

Chairman GONZALEZ. Thank you, Mr. Lowery, and thank you for your time and contribution, Congressman.

Mr. O'BRIEN. It is an honor to appear before your committee. I can better now understand the great esteem they hold you in in the House.

Chairman GONZALEZ. You are very generous. We will be in tinued communication with respect to this matter.

Mr. O'BRIEN. Thank you, Mr. Chairman.

Chairman GONZALEZ. We are very highly honored and privileged to have the Governor of the great State of Missouri, the Honorable Christopher S. Bond, representing the National Governors Association, and I will ask him to introduce the two gentlemen accompanying him for the record and then you may proceed as you see best, Governor.

We want to thank you for your statement, given to us in ample time to examine and consider.

STATEMENT OF HON. CHRISTOPHER S. BOND, GOVERNOR, STATE OF MISSOURI, REPRESENTING THE NATIONAL GOVERNORS' ASSOCIATION, ACCOMPANIED BY THOMAS WHITE, EXECUTIVE VICE PRESIDENT, COUNCIL OF STATE HOUSING AGENCIES, AND WAYNE MILSAP, CHAIRMAN, NATIONAL CONFERENCE OF HOUSING COMMISSION CHAIRPERSONS, AND CHAIRMAN, MISSOURI HOUSING DEVELOPMENT COMMITTEE

Governor BOND. Mr. Chairman, thank you very much. I am Christopher S. Bond. Accompanying me today on my right is Mr. Tom White, the executive vice president of the Council of State Housing Agencies. To my left is Wayne Milsap, chairman of the National Conference of Housing Commission Chairpersons, and also the chairman of our Missouri Housing Development Commission.

Having said that, let me extend to you my thanks and appreciation for the hospitality that you are showing us today, Mr. Chairman. We appreciate very much your giving us this opportunity.

I have submitted my testimony for the record, and with your permission we would ask that that be accepted for the record. My remarks will be briefer than the text which I have submitted. I might add that the order that you have in Washington makes the activities that are going on in our State capitals look a little less orderly, but we are still trying to get our job done. We do appreciate the chance to express the concern of the Nation's Governors, speaking through the National Governors' Association for the extremely serious housing problems which do confront the Nation and the citizens of the entire United States.

We are proposing broad policy objectives which we urge the committee to consider. I would like to commend the committee for recognizing the role of State and local governments in helping to meet the Nation's housing needs, particularly in your proposal for multifamily housing production. In addition, we also applaud inclusion in your legislation of the financing adjustment factor to fund the section 8 pipeline. This can be of immediate benefit to the State housing commissions and the people who depend upon them.

We, of the National Governors' Association, would like to work with your committee to assure needed legislation to provide housing for our low- and middle-income citizens. As you well know, sir, the United States is slipping toward a housing crisis. We are now in the third year of a severe housing slump. Some people call it a depression. Over 1 million people in the housing construction and real estate industries are unemployed. A slump of this proportion has a profound effect on the economic and fiscal condition of the

States, not to mention the condition of those individuals and those families who depend upon the industry.

State and local governments have suffered significant reductions in revenues. The fiscal distress of State governments has been compounded by increasing claims for unemployment insurance and welfare resulting from the widespread layoffs in the housing industry. More important is the fact that throughout the Nation our low-income population is finding it increasingly difficult to find affordable housing. Even middle-income people are frequently unable to purchase housing because of astronomical interest rates. I note that the problem is particularly acute for first-time homebuyers in their twenties and thirties. Young couples, many of them with husband and wife both working, tell me they are unable to afford a home of their own even though they have what they consider to be a good income. I am afraid young people are increasingly skeptical about whether they will ever be able to purchase a home.

Rental housing is becoming increasingly scarce. As a result of demolition, abandonment, and condominium conversion, we are losing more conventional housing rental units than we are building. Currently renters are residing in apartment stock in which over one-half the units were built in 1950 or earlier. Many of them are not energy-efficient, and many require substantial rehabilitation.

We do face serious problems in meeting the Nation's housing needs. We know that the homeownership sector also faces significant problems. I know you have had testimony detailing the problem and the members of this subcommittee and yourself are personally aware of these problems, so I will submit for the record the statistics which are contained in my testimony. But I want to emphasize for the benefit of the committee that it would be a mistake to underestimate what I think are the social implications of our inability to meet the growing housing demands of young adults who wish to buy their first home. Increasingly members of this generation despair that they will ever be able to realize the American dream of owning their own home. This to me is a significant and very serious problem which we must confront.

Speaking for the National Governors' Association, we recognize that the national policy goal of a "decent home and a suitable living environment for all Americans" continues to be a major priority for the 1980's. In 1980 the NGA adopted a policy position outlining our suggestions for strengthening the cooperative relationship between the Federal and State Governments in the areas of housing. With your permission I would like to submit the policy statement as an appendix to my testimony.

The Governors have long felt that no one level of government holds all the answers to our housing dilemma. Rather, the solution lies in the recognition that each level of government—Federal, State, and local—has an important role to play.

No two States are alike. Housing needs of one State or region are different from those of others. Our problems in Missouri are different from those you have in Texas, and both are different from those in Ohio or other areas of the Nation. Likewise, the solutions will vary from State to State. We are pleased that you have incor-

porated this principle in many of the provisions of your housing proposal contained in H.R. 5731.

In any program aimed at stimulating construction or rehabilitation of rental housing, State and local governments need maximum flexibility to tailor the program to their special needs. We believe the program should be compatible with mortgage revenue bond financing to assure that State and local governments will be able to leverage limited Federal funds.

The NGA urges the Federal Government to develop a strategy to avert housing abandonment. Existing Federal programs should provide States with flexibility to target them to buildings threatened with abandonment. If Congress enacts a voucher program, it should provide set-asides for units financed by State housing finance agencies. Most important, we urge you to draw upon the community development block grant approach to allow States to act as housing authorities for smaller communities that otherwise lack the resources and expertise to run their own housing programs.

Mr. Chairman, I believe the superb record of State housing finance agencies is perhaps the best demonstration of State capacity to respond to housing needs. Over the past 20 years State HFA's in 46 States, the District of Columbia, and Puerto Rico have provided low-cost permanent financing for approximately 400,000 single-family and 360,000 apartment units. These State housing projects show that States have the capacity to deal effectively with housing.

In my testimony I have set forth some examples and further statistics on what they have accomplished. The diversity of the programs underscores the need for continued flexibility. Housing finance agencies offer an efficient alternative to costly redtape and wastefulness frequently associated with centralized housing programs or Federal programs. The reliance on tax-exempt financing by State authorities results in sound management practices by the agencies, because the programs financed by mortgage revenue bonds are policed by the private market. The market demands programmatic success and enforces good management. Without high ratings, reflecting investor confidence in program security, mortgage revenue bonds just will not sell.

As you know, the ability of State agencies to continue their activities has been and still is threatened by the Treasury Department's recent proposal to restrict severely the issuance of tax-exempt revenue bonds, and by flaws in the Mortgage Subsidy Bond Act of 1980. Although I know that this committee does not have direct jurisdiction over those tax issues, I think it is important for us to utilize this opportunity to share with you the views of the Nation's Governors on the Treasury proposal.

Let me say briefly that we believe the public hearing requirement is unworkable and constitutes a burdensome intrusion into State authority. Instead of requiring hearings, we endorse a provision providing for public notice and comment. In our State we do afford a public hearing on all multifamily issues, but we believe the decision on how to involve the public is a matter best left to the States.

The 1-percent contribution the Treasury proposes would violate many State constitutions. Simply, there is no way that those funds could be provided under the provisions of many State constitutions.

Furthermore, we do not feel a contribution requirement does anything to insure a greater public purpose.

The requirement that users of tax-exempt bonds forgo the benefits of accelerated cost recovery will effectively eliminate State financing of rental housing for low- and moderate-income families. Last year Congress enacted a special tax benefit for housing defined by the Tax Code as low- and moderate-income housing. The Treasury proposal would take away many of the tax benefits which are essential to raising the funds necessary.

But in addition to rejecting the Treasury Department proposal, we would hope that Congress will take action to remove some of the remaining unworkable technical restrictions contained in the Mortgage Subsidy Bond Act of 1980. Operating on the belief that unlimited issuance of mortgage revenue bonds posed a threat to Federal revenues and the health of the bond market, the Congress passed legislation to limit bond volume and target the proceeds of the bonds on the basis of need. We do not quarrel with the general thrust of the legislation. Unfortunately, some of the technical provisions of the statute unrelated to the targeting and volume restrictions have made mortgage revenue bond programs virtually unworkable.

Despite regulatory relief to relax some of the restrictions, 1981 MRB issues covered by the act totaled less than $2 billion, less than 15 percent of the congressionally imposed volume limit. The majority of these issues required a contribution from the housing finance authority's own reserves or State appropriation to cover issuance cost shortfalls resulting from restrictions on the use of bond proceeds. To help remedy the problems that have surfaced under the act, we urge Congress to pass the mortgage revenue bond amendments contained in H.R. 4717, a bill currently in conference.

We also would urge Congress to consider extending the 1983 sunset provision for single-family bonds contained in the 1980 Act. The statute was enacted over 15 months ago, yet until yesterday the delay in the promulgation of regulations and the technical flaws in the act made it impossible for the Missouri Housing Development Commission to seek bids for bonds under the permanent rules established in the act. We feel that extension of the sunset provision is only fair. Extension would permit the States to make up for the lost time.

The Council of State Housing Agencies estimates that $10 billion in MRB's would be sold this year if the arbitrage level were raised. One billion dollars in MRB's will directly finance 18,500 moderately priced homes at below-market rates, and provide 23,000 man-years of housing-construction-related jobs. In the first year, $1 billion in mortgage revenue bonds will generate $126 million in Federal personal and corporate income taxes, and $54 million in State and local tax revenue as well. I certainly do not want to suggest that mortgage revenue bonds are the panacea for all our economic and fiscal ills. Nevertheless, they are essential to the operation of State housing agencies.

I have focused on HFA's because they demonstrate the willingness, the ability, and the mechanism of the States to help contribute to an effort by all levels of government to provide adequate housing for all Americans.

Mr. Chairman, the National Governors' Association and I look forward to working with you and your committee to achieve this goal.

[Governor Bond's prepared statement, on behalf of the National Governors' Association, follows:]

National Governors' Association

Richard A. Snelling
Governor of Vermont
Chairman

Stephen B. Farber
Executive Director

Testimony of

The Honorable Christopher S. Bond

Governor of Missouri

Before the

Subcommittee on Housing & Community Development
Committee on Banking, Finance & Urban Affairs
U.S. House of Representatives

Regarding

Housing Availability and Affordability

April 1, 1982

HALL OF THE STATES • 444 North Capitol Street • Washington, D.C. 20001 • (202) 624-5300

Mr. Chairman, thank you for permitting me to appear today on behalf of the National Governors' Association. I am appearing today in my capacity as chairman of the NGA Committee on Community and Economic Development, which has jurisdiction over housing issues. I appreciate this opportunity to express the concern of the Governors' Association over the serious housing problems our nation faces and to set forth some broad policy objectives which we think the committee should consider this year.

First, let me commend the committee for its recognition of the role of state and local governments in helping meet the nation's housing needs, particularly in your proposal for multi-family housing production. Mr. Chairman, the NGA welcomes the opportunity to work with you and the committee to provide needed housing for our low and middle-income citizens.

The United States is slipping toward a housing crisis. We are now in the third year of a severe housing slump. Some people call it a depression. Over one million people in the housing construction and real estate industries are unemployed. A slump of this proportion has a profound effect on the economic and fiscal condition of the states. State and local governments have suffered significant reductions in revenues from property taxes, home sales and related retail sales taxes, personal income and corporate taxes, as well as fees associated with sale of new and existing real estate. The fiscal stress of state governments has been compounded by increasing claims for unemployment insurance and welfare resulting from the widespread and sustained layoffs in the housing industry.

In Missouri and throughout the nation, our low-income population is finding it increasingly difficult to find affordable housing. Our middle-income

population is fr e m

astronomical interest rates. me p M

homebuyers in their twenties and rties. , r

both husband and wife working, tell me that they are unable

of their own, even though they have what is considered a go

Missouri, young people are increasingly skeptical about w ever

be able to purchase a home.

Rental housing has become increasingly scarce. As a result of demolition, abandonment and condominium conversion, we are losing more conventional rental units than we are building. Currently, renters are residing in apartment stock in which over half the units were built before 1950. Consequently, most of these units are not energy efficient and many require substantial rehabilitation. The owners of these apartment buildings are frequently saddled with maintaining decaying structures and paying for significantly increased operating costs due to rapidly escalating fuel prices, particularly in states like Missouri where natural gas is increasingly expensive. Current interest rates make it prohibitively expensive for most apartment owners to undertake rehabilitation through refinancing. Faced with this problem, many landlords are forced to choose disinvestment and ultimately, abandonment. George Sternlieb of Rutgers University estimates demolition and abandonment losses to the rental stock of the United States during the 1980s will average over 578,000 units annually.

The Council of State Housing Agencies predicts that during the 1980s between 290,000 and 400,000 new rental units will be required to meet the needs created by formation of new households. When losses to the existing stock are

added to household formation statistics, we see - at a minimum - an annual rental production requirement of 600,000 units to maintain the current rental supply. With the Advance Mortgage Corporation reporting that in 1981 conventional apartment starts were slightly over 100,000, it becomes evident that we are facing a serious problem in meeting the nation's multi-family housing needs.

The home ownership sector is equally beset by problems. In 1970, when the average new home cost $23,000 with fixed rate, long-term conventional financing in the eight percent range, the middle-income family could afford to purchase a home; today barely ten percent of U.S. families are able to afford a medium-priced home. Since the early 1970s new home prices have skyrocketed by over 250 percent and mortgage rates have more than doubled. It appears that the eight percent interest rate, thirty-year mortgage has gone the way of the five cent chocolate bar. Although increases in housing prices may abate during the 1980s, it is very uncertain whether prices will return to a level that allows access of middle-income families to new housing on the scale that was experienced in the 1970s. Furthermore, during the 1970s, a major source of housing for first-time buyers was previously-owned housing. High interest rates and historically low levels of new housing construction have severely depressed the housing resale market.

High interest rates also pose a serious problem for middle-income persons who seek loans to rehabilitate or improve the energy efficiency of their homes.

Assuming a low replacement rate for single-family units (of one-half of one percent per year or 300,000 units), depressed rates of ownership household formation (of one million per year), and minimal vacancy requirements (100,000 units per year), the Council of State Housing Agencies predicts an annual ownership housing production requirement of over 1.4 million units to

maintain adequate levels of housing availability during the 1980s. At present, it seems unlikely that we will attain these levels.

I think it would be a mistake to underestimate the social implications of our inability to meet the growing housing demands of young adults who wish to buy their first home. Increasingly, members of this generation despair that they will ever be able to realize the American dream of home ownership. President Reagan and Congress have committed the nation to a long-overdue effort to increase our productivity and improve our competitive edge in the international market place. The success of this commitment will rest upon people in their twenties and thirties. We run the risk of undermining our efforts if they lose confidence in their own future. If we hope to enlist the support of this generation in the campaign to increase America's productivity and preserve our free market system, we must convince them that their efforts will improve their well-being. We must convince them that they will not be required to sacrifice the dream of home ownership as the price for economic revitalization.

The National Governors' Association recognizes that the national policy goal of "a decent home and a suitable living environment for all Americans" continues to be a major priority for the 1980s. In 1980 the NGA adopted a policy position outlining our suggestions for strengthening the cooperative relationship between the federal and state governments in the area of housing. With the permission of the committee, I would like to submit the policy statement as an appendix to my testimony.

The Governors have long felt that no one level of government holds all the answers to our housing dilemma. Rather, the solution lies in the recognition that each level of government - federal, state and local - has an important role to play.

No two states are exactly alike. The housing needs of one state or region are different from those of another. Our problems in Missouri are as different from those of Texas as they are from those in Ohio. Likewise, the solutions will vary from state to state. Mr. Chairman, we are pleased that you have incorporated this principle in many of the provisions of your housing proposal contained in H.R. 5731.

In any program aimed at stimulating construction or rehabilitation of rental housing, state and local governments need maximum flexibility to tailor the program to their special needs. We believe the program should be compatible with mortgage revenue bond financing to ensure that state and local governments will be able to leverage limited federal funds.

The NGA urges the federal government to develop a strategy to avert housing abandonment. Existing federal programs should provide states with flexibility to target them to buildings threatened with abandonment. Expansion of the urban homesteading program and provision to set aside some form of low-income housing for this purpose should be given priority consideration in developing an overall approach to the problem of abandonment. If Congress enacts a voucher program, it should provide a set-aside for units financed by state housing finance agencies. We would also urge you to draw upon the Community Development Block Grant approach to allow states to act as housing authorities for smaller communities that otherwise lack the resources and expertise to run their own housing programs.

Over the years, states have demonstrated their willingness and ability to address housing issues. We have taken measures to use state statutory and regulatory authority to promote housing affordability in such areas as zoning

and subdivision regulations, promoting the supply of developable land, structural regulation, direct financial assistance through mortgage revenue bonds and abatement of property taxes for housing construction or rehabilitation in distressed areas. At the request of HUD Secretary Samuel Pierce, the NGA is cooperating with a national demonstration program to promote affordable housing.

The superb record of state housing finance agencies (HFAs) is perhaps the best demonstration of state capacity to respond to housing needs. Over the past twenty years, state HFAs in 46 states, the District of Columbia and Puerto Rico have provided low cost permanent financing for approximately 400,000 single family and 360,000 apartment units. All told, these agencies have an outstanding debt of over $25 billion dollars. In my state, legislation authorizing creation of the Missouri Housing Development Commission was enacted in 1969 and the Commission issued its first bonds in 1970. Total debt outstanding on July 1, 1981 was $647,858,400. We have financed 9,000 single family homes with mortgages totalling $222.6 million and 14,848 multi-family units with mortgages totalling $344.5 million.

Nationwide, state HFAs have financed and successfully generated about one-third of the Section 8 program. In Missouri, our agency has used mortgage revenue bonds to finance 6,998 Section 8 units and 1,868 Section 236 units.

A number of HFAs have initiated programs to provide low interest rate funds to improve the energy efficiency of existing rental properties or perform moderate rehabilitation. The Minnesota HFA has provided financing secured with second mortgages to install energy conserving improvements in about fifty rental projects throughout the state. The Virginia Development Authority has

used the FHA 241(e) mortgage insurance program to make multi-family energy conservation loans. Unfortunately, other HFAs have been stymied by the Mortgage Subsidy Bond Act provisions which restrict the use of bond proceeds for multi-family projects with less than twenty percent low-income tenants.

A number of HFAs have assisted state historic preservation programs by coordinating rehabilitation efforts with other state and local agencies. Several agencies in rural states have played a major role in financing Famers Home Administration multi-family projects. Many HFAs provide congregate housing for the elderly. Other HFA programs include housing for the handicapped, battered women shelters, moderate-income condominium conversion and Indian housing.

These state housing programs show that states have the capacity to deal efficiently with housing. The diversity of state programs underscores the need for continued flexibility inherent in the principles of new federalism. Housing finance agencies offer an efficient alternative to costly red-tape and wastefulness frequently associated with centralized federal programs. The reliance on tax-exempt financing by state HFAs results in sound management practices by the agencies. Programs financed by mortgage revenue bonds are policed by the private market. The market demands programmatic success and enforces good management. Without high ratings, reflecting investor confidence in program security, mortage revenue bonds will not sell.

As you know, the ability of state agencies to continue their activities is threatened by the Treasury Department's recent proposal to restrict severely issuance of tax-exempt revenue bonds and flaws in the Mortgage Subsidy Bond Act of 1980. Although I know this committee does not have direct jurisdiction

over these tax issues, I think it is important to discuss Treasury's proposal because it would effectively foreclose the vast majority of state housing efforts.

On February 26, the Treasury released the provisions of the Administration's revenue enhancement initiative. The effect of some of these provisions would be to render mortgage revenue bonds (MRBs) virtually useless as a tool for financing. The legislation would require: 1) Bond approval by the highest elected official or legislative body following a public hearing; 2) After December 31, 1985 a contribution equal to one percent of the face amount of the bonds must be made by the issuer. The contribution can take several forms including a cash payment, a tax credit or abatement, a guarantee or insurance; 3) Accelerated cost recovery would be denied to revenue bond users. They would be required to use the straight-line method of depreciation with a thirty-five year period required for real estate; 4) Bonds must be in registered form; 5) Restrictions on the investment yield from the use of the proceeds of the obligations are extended to reserve funds and funds held during the temporary construction period. Bond costs may not be taken into account in determining the yield for purposes of the arbitrage limitations.

We believe that the public hearing requirement is unworkable and constitutes a burdensome intrusion into state authority. Instead of requiring public hearings, we endorse a provision which would require the issuing authority to publish a list of proposed issues and provide for an opportunity for public comment. Many states may choose of their own volition to expand public notice into a full public hearing. In Missouri, for example, we conduct public hearings on all multi-family issues. However, we believe that under the principles of

our federal system this type of requirement is best left to the discretion of the state government.

The one percent contribution requirement contained in the Treasury proposal would violate many state constitutions. Furthermore, it does nothing to ensure any greater public purpose than already exists.

Finally, the requirement that users of tax-exempt bonds forgo the benefits of accelerated cost recovery will effectively eliminate state financing of rental housing for low and moderate-income families. Last year Congress enacted a special tax benefit for housing defined by the tax code as low and moderate-income housing. The provision permits a two hundred percent write-off of construction interest and taxes. The IRS definition for low and moderate-income includes housing assisted by Section 8 or other federal subsidy, eligible for the FHA 221-d-3 low and moderate-income program, or a state or local equivalent of that program. Basically, housing regulated as to rents and limited as to profit is eligible. It is my understanding that state programs usually provide for limited dividend mortgagors whose rents are regulated and whose profit is limited to no more than six to ten percent equity.

Given income and program restrictions, coupled with the reality that low and moderate-income families are unable to afford high rents, profit sufficient to attract equity capital must be achieved through syndication of the tax shelter. The profit will not be sufficient to attract capital if accelerated cost recovery is denied.

In addition to rejecting the Treasury Department proposal, Congress should take action to remove the unworkable technical restrictions contained in the Mortgage Subsidy Bond Act of 1980. Operating on the belief that unlimited

issuance of mortgage revenue bonds posed a threat to Federal revenues and the health of the bond market, Congress passed legislation to limit bond volume and target the proceeds of the bonds on the basis of need. The general thrust of this legislation was admirable and the states supported its goals. Unfortunately, technical provisions of the statute, unrelated to the targeting and volume restrictions, have made MRB programs virtually unworkable. Despite regulatory action by the Treasury Department to relax some of the restrictions, 1981 MRB issues covered by the 1980 Act totaled less than $2 billion, less than fifteen percent of the Congressionally imposed volume limit. The majority of these issues required a contribution from HFA reserves or state appropriation to cover issuance cost shortfalls resulting from restrictions on the use of bond proceeds.

To help remedy the problems that have surfaced under the Mortgage Subsidy Bond Act, Congress should pass the MRB amendments contained in H.R. 4717, a bill which is currently awaiting conference. The amendments would define the low-income requirement for multi-family housing as a ten-year term of twenty percent occupancy for families of less than eight percent of median income. Present law implies a twenty-year term. The amendment allows for 1 1/16 percent basic yield compared to the present restriction, and sets a sliding scale for issues of less than $100 million up to 1 1/8 percent at $30 million.

Congress should also consider extending the 1983 Sunset provision for single-family bonds contained in the 1980 Act. The statute was enacted over fifteen months ago. Yet until yesterday delay in the promulgation of regulations and technical flaws in the Act made it impossible for the Missouri

Housing Development Commission to seek bids for bonds under the permanent rules established in the Act. Extension of the Sunset provision would permit the states to make up for lost time.

The Council of State Housing Agencies estimates that $10 billion in MRBs would be sold this year if the arbitrage level were raised. It should be noted that a volume of $1 billion in MRBs will directly finance 18,500 moderately priced homes at below-market rates and provide 33,000 man-years of housing contruction-related jobs. In the first year, $1 billion in mortgage revenue bonds will generate $126 million in federal personal and corporate income taxes and $54 million in state and local tax revenue. Annual real estate taxes on 15,000 new MRB-financed units would total over $18.5 million, nearly offsetting federal revenue expenditures associated with $1 billion in bonds. When one considers all taxes, mortgage revenue bonds prove to be a net generator of tax revenues for federal, state and local governments.

I certainly do not want to suggest that mortgage revenue bonds are the panacea for all our economic and fiscal ills. Nevertheless, they are essential to the operation of state housing agencies. I have focused on HFAs because they illustrate the willingness and ability of the states to help contribute to an effort by all levels of government to provide adequate housing for all Americans.

Mr. Chairman, the NGA and I look forward to working with you and the committee to achieve this goal.

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HOUSING ISSUES AND NEEDS

The 1949 national policy goal of "a decent home and a suitable living environment for all Americans" continues to be a major national priority for the 1980s. While significant progress has been made since the adoption of this goal, the nation is still far from meeting the need for decent and affordable housing.

The supply of housing available in many markets is not adequate to meet the demand; the shortage is particularly acute in the rental housing sector and in regions experiencing rapid population growth. Housing costs have risen faster than incomes, making decent housing unaffordable for many people and raising the costs of subsidy programs. The cost of housing is a particular problem for low and moderate income families, and the barriers to choice posed by racial and other discrimination have not yet been fully overcome. Increases in one of the major components of housing costs -- energy -- have served to further exacerbate the housing problems in the 1980s.

Housing needs seem to continually exceed the resources available to satisfy them. Direct subsidy programs must therefore be focused on meeting the housing needs of the low and moderate income population. Other policies and programs, designed to improve the functioning of the housing market generally, should place major reliance on the private sector to finance, build, and maintain an adequate supply of housing.

Achieving the national housing goal adopted in 1949 should remain a high priority for the federal government, the states, and the private sector during the 1980s. The suggestions outlined below are designed to strengthen cooperative state-federal efforts in the area of housing and assure continued progress toward achievement of this national policy goal.

Addressing Problems of Supply and Cost

In the 1980s, about 42 million Americans will reach the prime home-buying age of 30, compared to about 30 million in the 1970s. The trend toward more single-person households not only increases aggregate demand for housing, but also results in changes in the type of housing units in demand. Growth in demand also results from homeownership being an excellent personal investment in inflationary times.

The housing market in many areas of the country has been unable to satisfy this growth in demand. The shortfall in supply is attributable to two major factors: the shortage of capital for new residential construction and the rapid escalation of housing costs.

Housing construction is one of the most cyclically sensitive sectors of the economy. Minor fluctuations in interest rates can produce major changes in the mortgage market and production levels for new housing. Although the recent growth of long-term certificates of deposit and expansion of the secondary mortgage market have mitigated this problem somewhat, residential construction still remains highly sensitive to cyclical changes in the economy.

Sharp increases in the costs of housing over the past decade have placed the dream of owning a single-family home beyond the reach of a growing proportion of households. The market has not provided new alternative home ownership opportunities (e.g., new condominiums) in sufficient quantities to satisfy the demand; nor has construction of new multi-family rental housing been sufficient to meet rental demand. Increases in construction and financing costs have been a significant constraining factor in both the single-family and multi-family housing markets. In many areas, operating costs for multi-family rental housing have increased more rapidly than rents, further eroding investment and contributing to severe shortages of rental housing.

The present housing crunch can be attributed in part to the cumulative effects of government monetary and tax policies, environmental and other restrictions on residential construction, rent control and condominium conversion, and program investment decisions. Because government policies exert a major influence on the housing market, solutions to the related problems of supply and cost depend, in part, on governmental action to remove unnecessary barriers to a smoothly functioning housing market. Direct government involvement should be focused on those areas where the private sector is unable or unwilling to address the needs of particular markets or population groups.

Federal Actions Suggested

- A more stable flow of capital into residential construction would result in a more smoothly functioning housing market and a lower rate of growth in housing costs. A thorough reevaluation of the regulation of thrift institutions and the effects on housing finance of conventional monetary policy should be undertaken to identify alternative approaches that can "smooth out the bumps" in the availability of funds for residential construction. Particular attention should be given to measures that would enable thrift institutions to compete more effectively for funds during periods of high short-term interest rates.

- Federal actions to maintain the supply of mortgage money through secondary mortgage market participation and support by government financial institutions (FNMA, FHLMC, GNMA, FHLBB) should be examined to assure that they counteract the effects on the private mortgage market of cyclical changes in the economy.

- Home ownership subsidy programs should be targeted to low and moderate income households and should be reviewed regularly to ensure that interest rates and mortgage limits are set at realistic levels.

- To reduce the extreme effects of the money market cycle on mortgage availability, private lenders should be encouraged to offer more flexible mortgages (e.g., variable rate, graduated payment), without precluding consumer choice of conventional financing.

- Implementation of a shallow subsidy approach should be considered to increase the supply of rental housing, provided such a program does not reduce commitments to low income rental housing needs. Such a program should permit states the flexibility needed to assure production of rental housing in areas where the problems are most severe. Determination of the mix between new and existing housing units for purposes of low income rental subsidy programs should be based on community needs, as reflected in locally developed housing assistance plans.

- It is imperative that Congress avoid placing unnecessary restrictions on states' use of mortgage revenue bonds to finance home ownership and rental housing in areas where the private sector is not adequately meeting the demand. While there is a need for some federal limits on the use of such bonds, major responsibility for regulating mortgage revenue bonds should continue to reside with the states.

- Federal housing policies should recognize the special needs of rural areas. In particular, federal housing programs should permit sufficient flexibility for scattered site development of both rental and single-family housing in small communities and sparsely populated areas.

- An explicit federal strategy to avert housing abandonment should be developed. The most effective strategies are likely to be those that combine and target the resources of both federal and state government. Existing federal programs therefore should provide states with flexibility to target them to buildings threatened with abandonment. Expansion of the urban homesteading program and provision to set aside Section 8 units for this purpose should be given priority consideration in developing an overall approach to the problem of abandonment.

State Actions Suggested

- Over forty states have established housing finance agencies that use tax-exempt revenue bonds to meet the housing needs of low and moderate income residents. States are also responsible for overseeing the issuance of mortgage revenue bonds by local units of government and for ensuring that these programs conform with legitimate public purposes. States should continue to assure that this indirect federal subsidy is used in a responsible and effective manner to fill gaps in the private mortgage market.

- While federal programs play a significant role in stimulating new condominium construction, regulation of conversion and protection of tenants' interests can be addressed most effectively in response to particular market characteristics at the state and local level. The loss of rental units and displacement of tenants due to condominium conversions are phenomena best regulated at the state level.

- As state and local public employee pension funds grow in importance in national capital markets, they are increasingly able to play an important role in housing finance. States should consider using their pension funds to provide mortgages to public employees, shared-equity programs to lower initial downpayments in return for a share of eventual capital gains, and direct provision of loans for single-family housing.

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Meeting Low Income Housing Needs

While national housing policies should be designed to assure an adequate supply of housing to satisfy the demands of the general population, particular attention must be given to meeting the needs of low income households. Federal subsidy programs for new construction and substantial rehabilitation of rental housing are characterized by high unit costs. Although rent subsidies for existing housing units may appear to lower unit costs and stretch the housing assistance dollar further, this approach is not responsive to low income needs in areas where the supply of existing housing is tight.

The range of federal subsidy programs directed to meeting low income housing needs is basically adequate. The major needs are to maintain sufficient levels of activity, improve program flexibility and adaptability, and assure effective administration of programs in response to local needs and conditions.

Federal Actions Suggested

- As housing costs continue to increase at a faster pace than the overall cost of living, the size of the target population for federally assisted housing programs inevitably will increase. For this reason, low income housing programs should be maintained at current activity levels, with increases as resources permit.

- To increase program effectiveness in times of limited resources, federal programs should be flexible enough to respond to a wide variety of local market conditions and needs. One of the more effective partnerships has involved use of Section 8 rent subsidies set aside for units financed by state housing finance agencies. HUD should increase the Section 8 set-asides and assure sufficient continuity in the set-asides to enable states to develop well-planned project "pipelines."

- To ensure that federal low income housing resources are directed to projects where the need is most acute and the impact greatest, program dollars should be allocated in accordance with local, regional, and state plans and priorities.

- The Farmers Home Administration has negotiated formal cooperative agreements with a number of states to assure that federal funding decisions are consistent with overall state priorities. HUD should make the necessary program adjustments to permit and encourage similar agreements with states.

- Greater flexibility is needed in the Section 8 assisted housing unit mix to permit states or local agencies to shift resources to new construction or substantial rehabilitation when vacancy rates are too low to make use of existing housing. Fair market rent determinations should be pegged closely to local market conditions and should be adjusted frequently as market conditions change.

- Housing program regulations should be as simple and straightforward as possible and should be consistent among all agencies that finance housing, so red tape costs are minimized and private sector participation is not discouraged.

State Actions Suggested

- States should continue the roles they have played successfully -- developing appropriate housing strategies, filling in gaps between federal programs, complementing and adapting federal programs to work in local settings, and providing technical assistance to local agencies and private developers who utilize federal and state programs.

- Because state housing finance agencies (HFAs) have been particularly successful in forging linkages with federal programs, states should continue to strengthen their HFAs and target their resources to complement federal and private sector efforts to meet low income housing needs.

- Many states have found it beneficial to act as housing authorities for smaller communities that otherwise lack the resources and expertise to participate in the Section 8 and public housing programs. This approach warrants consideration by other states.

Ensuring Fair Housing Policies and Practices

The rights of free choice in the housing market are protected by federal and state laws. Enforcement of federal fair housing laws is delegated to states that have comparable legislation. This augments the enforcement provisions of the federal law with the generally greater authorities the states possess. Effective enforcement of federal and state fair housing laws is an important step toward assuring equal opportunities and preventing overt discrimination in housing.

However, there are some subtle barriers to freedom of housing choice that can be more difficult to identify and overcome (e.g., mortgage or insurance redlining, exclusionary zoning practices). In addition, the market often does not meet the needs of those with special housing requirements and consequently deprives them of the range of choice available to others. While federal and state regulations, enforcement mechanisms, and disclosure requirements are necessary tools to eliminate unfair housing practices, only through the active involvement and commitment of the private sector can the promise of equal opportunities in housing be fulfilled.

Federal Actions Suggested

- Enforcement of the federal (and state) fair housing statutes is uneven, in part because of the federal government's reliance on the powers and resources of state agencies. To improve the enforcement record, the federal government should provide sufficient resources to the states for enforcement.

- The Home Mortgage Disclosure Act is an important instrument for overcoming mortgage redlining, one of the indirect obstacles to equal opportunity in housing. The program should be made permanent and its implementation should continue to be carried out as diligently as in its initial years.

- In recent years, a number of federal initiatives have been undertaken to encourage expansion of housing opportunities for the disadvantaged through demonstration programs, incentive mechanisms, and the establishment of priorities within existing federal programs. Efforts to develop "partnership" agreements with state and local governments represent a similar positive approach to fair housing. The Governors endorse the provision of positive incentives for achievement of fair housing through the development of a cooperative partnership approach to shared federal-state objectives.

State Actions Suggested

- States should continue aggressive enforcement of state and, where delegated, federal fair housing laws. In addition, states should encourage affirmative efforts by local governments to eliminate exclusionary zoning and other local restrictions that pose barriers to freedom of choice in housing.

- State housing finance programs can be used to expand housing opportunities as a positive complement to enforcement of antidiscrimination laws. States should also assume a leadership role in working with the full range of commercial sectors involved in housing (e.g., builders, owners of rental housing, realtors, lending institutions) to gain active private sector involvement to eliminate discriminatory practices and assure equal housing opportunities.

Adopted August 1980.

Chairman GONZALEZ. Thank you very much, Governor, for not only your most informative, but a most responsive and perceptive statement, and at this point I do want to take this opportunity to recognize our colleague from Missouri, Congressman Emerson, who has legislation and appeared before this subcommittee last week, and since he is from Missouri, and he is very much concerned, and I am going to ask him to further welcome you.

Mr. EMERSON. Thank you very much, Mr. Chairman.

I am delighted to have the opportunity to welcome you here, Governor Bond. I apologize that I was not here at the outset, but I was in another subcommittee testifying about another one of our problems, a problem in agriculture, namely the soybean cyst nematode, and trying to get funding for research.

I am delighted that you are here to talk about this important subject as it relates to the housing industry. I did testify last week in support of the goals that you are speaking to here, and look forward to working with you and with this distinguished subcommittee and committee in getting them implemented. I commend you for making the trip to Washington to speak on behalf of Missouri and on behalf of your fellow Governors. You have been well heard by this committee. It is an outstanding committee that is very sensitive to the problems that you are trying to address, and I think you can expect a good reaction from the committee.

Governor BOND. Thank you, Congressman.

Chairman GONZALEZ. Thank you very much, Mr. Emerson.

Governor, as I said, your statement was so thorough that several of the questions I thought I would ask were taken care of. They would have been along the lines that we asked State housing agencies.

As you pointed out, enabling legislation was approved in 1963 in Missouri. In my own State of Texas we still have yet to enact something that would even represent a program similar to yours.

I guess one of the biggest disappointments I have had since I have been in this Congress 20 years was the Secretary of HUD coming before us this morning for better than 2½ hours and not one time referring to the bill around which these hearings are held. What this does, intended or not, is reduce us automatically and willy-nilly to an adversary position, which we realize is futile. And so to have you come here and address H.R. 5731, our bill, is very gratifying, and I am grateful that you did.

From the standpoint of your own State, if we were lucky enough to get congressional approval of the rental housing program provisions, how would the State of Missouri use these Federal funds to produce the much-needed rental housing: through interest subsidies, up-front capital, grants, or direct loans? Would you be in a position to say what seemed to be the potential use of this mechanism?

Governor BOND. I was just conferring with the chairman of my housing development commission, which is a separately established and independent body, but the Governor does have one vote on it. The chairman controls the committee, however, with an iron hand, and bowing to his judgment, I would say that we would explore a number of different ways.

Our housing development commission as you kindly suggested is a very effective ongoing operation. It has built up some reserves over the years, and frankly it was only because it had reserves available that we were able to go to the market yesterday for the single-family issuance. I am sure that there are States which would be able to provide housing opportunities if the money would be available, as we have done in Missouri because we have an established agency. Certainly, we would explore either a subsidy for the rent or perhaps some up-front contribution to the bond issue so that there would be an overall reduction for the spread over the entire amount of the issue. This is something on which we have not made a final determination. We would await the provisions of whatever Federal law is enacted and any accompanying regulations.

Chairman GONZALEZ. Thank you very much. I am changing the question around. In every State that we visited last year and this year, the answer was the same on the part of the housing officials. That is if we do not succeed, and there is nothing, and the rest or substantially the rest of the President's budget recommendations as of February 8 were to be honored by the Congress, meaning that there would be sharp, extremely sharp reductions if not elimination of some of these grants and other subsidies for the States, how would that impact on your ability to carry on the basic mission of the housing agency of the State of Missouri?

Governor BOND. Mr. Chairman, basically our problems relate to the provisions of the Mortgage Subsidy Act of 1980. We need relief from those provisions. The only reason we have been able to issue some bonds is because of our good financial situation. But probably the most significant action which Congress could take right now would be to free up or open up the pipeline on the section 8 funds, which have already been appropriated. We do not seek new appropriations because we know the difficult fiscal and budgetary conditions faced by the Federal Government. But we feel that with the money that is in the pipeline we could make a substantial amount of progress on the multifamily program.

Chairman GONZALEZ. Let me ask a question here. In setting up your authority, what is the basis of funding for the housing agency in Missouri?

Governor BOND. The housing agency in Missouri is now entirely independent of State general revenue. We face a very tight financial condition in the State. In my first term as Governor back in the early seventies we contributed $1 million of general revenue to the Housing Development Commission to get it started. It has operated with the arbitrage that it received on the bonds that it issued. Next month the housing commission will return approximately $1.9 million to our State treasury, representing the initial contribution plus the interest on it for the years that the general revenue funds have been used. With that payment which is scheduled for April 21, it will be completely freestanding. It will not be dependent in any way on State appropriations.

Chairman GONZALEZ. Sincere congratulations. I guess nothing more need be said as to the definition of success there.

Let me just conclude by saying that Texas has been impacted ·· ·ough its history very much by Missouri. Some of the most

prominent Texans came from Missouri, Stephen Austin, Moses Austin, were all Missourians. The name Milsap is prominent in my district. I asked him if he was related to a young attorney in San Antonio running for district attorney by the name of Milsap.

As I said, from the Eastern Shore of Maryland and Virginia to California in a period of less than a year, and Americans—you know, it was the only really inspiring thing, even though the notes were depressing and the testimony was demoralizing, the people are there, and I salute you in Missouri for having the faith in people, which we seem to have lost on the national level.

Mr. Lowery.

Mr. LOWERY. Thank you, Mr. Chairman.

Governor, welcome to the committee. I appreciate your sage comments and your testimony. Currently the House and Senate have before them in conference legislation that we passed last fall and I believe the Senate has passed back in December contained in H.R. 4717 as it relates to mortgage revenue bonds, and it gives you a little bit of the flavor of this place—here we are 6 or 7 months after we passed it and 4 months after the Senate passed legislation, it is just now getting around to conference, which indicates the problems that we are facing.

Yesterday with regard to that conference, the House Republican Task Force on Housing adopted unanimously a resolution which I will read and ask for your comments. Basically we were asking that we go beyond the scope of the conference on an emergency basis to incorporate many things you asked for.

Whereas, the Nation's housing industry is an important part of the Nation's economy; and

Whereas, the level of housing construction is at an historic low; and

Whereas, there is currently in conference between the House and Senate a bill which amends the mortgage revenue bond program; and

WHEREAS, this program could be expanded to provide immediate and low-cost assistance to the Nation's housing industry since State agencies are poised and ready to issue bond packages within 30 to 60 days of Congressional action and issuances of approximately $10 billion could be made in 1982, thereby assisting 150,000 to 185,000 units: Now, therefore, be it

Resolved, That the Task Force supports amendments to H.R. 4717 (pending in conference) which are designed to expand the mortgage revenue bond program related to single-family homes. Specifically, H.R. 4717 should be amended to assist the purchase of homes with a purchase price of 110 percent of the average area purchase price regardless of whether the home is in a targeted area and regardless of whether the mortgagor is a first-time home buyer. The per State limitation on the aggregate amount of mortgage revenue bonds issued should be increased to $400,000,000 from $200,000,000 during 1982 for any State which does not have a higher limit based on 9 percent of the annual average annual aggregate principal amount of mortgages originated in the State over the immediate preceding 3 years. In addition, the change in the arbitrage limit made by the Senate bill should be superseded for 1982 to allow for a 1.25 percent arbitrage.

Your comments please, Governor.

Governor BOND. First of all, I believe several of the points that you mentioned there are supported by the National Governors' Association. In particular, we feel that the arbitrage should be moved up at least to 1.25 percent. We would suggest perhaps 1½ percent to give the housing authorities the needed flexibility. We definitely favor relaxing the first-time home purchaser requirement because of our difficult economic times. There are not that many first-time

home purchasers who are in the market. There are others who need that assistance.

I would question perhaps the sense of the resolution that it should double from $200 million to $400 million the amount of bonds which can be issued. Frankly, in Missouri we would be happy if we could just issue $200 million in bonds. We need to get that out. We realize there may be some questions. We do not quarrel with the desirability of putting some limitation on the amount of bonds that can be issued, and we were willing I believe to accept that limitation. All we ask is the authority to issue our allotment under the 1980 statute.

We would, as I indicated earlier, like to have the 1983 sunset provision removed. Perhaps with that caveat, I would say that we would be extremely supportive of your resolution. If I may check just a minute—our staff advises me that the resolution would be consistent with not only the Council of State Housing Agencies position, but the official position of the National Governors' Association.

Mr. LOWERY. Thank you. It has taken us 6 or 7 months to get this far, we are not there yet, but at least we appear to be moving in the right direction to provide relief for a hard-hit industry and get more Americans who have particular needs for housing sheltered as quickly as we can. Thank you, sir.

Chairman GONZALEZ. Mr. Emerson, did you have any questions?

Mr. EMERSON. No.

Chairman GONZALEZ. Let me say for the record that I was one of those that did not vote for that Home Mortgage Revenue Act, I believe in 1980, and mostly because of my State experience, since I had the honor of serving in the Texas State Senate for 5 years. As a matter of fact, I was the author of the enabling legislation on slum clearance and urban renewal for the State of Texas, which had failed for 12 years before in 1957—it took that long. Some of the features of the bill that were not debated but were in the fine print, and some of the obvious vacuums or lapses in the wording of the legislation. I was concerned that some subsequent interpretations by unknown human beings with differing standards of interpretation would be making the States and local entities quite vulnerable.

I am very sorry that some of this has come to pass. I was hopeful that I had been wrong, but I do want the record to show that I was not one of those that voted for that, for that reason. I want the record also to show that I am in wholehearted support of your efforts to try to not only modify the regulations, but perhaps the law itself, and certainly I am committed to doing something about it.

I think the points you have made here are invaluable, and we intend to transmit your testimony to members of the Ways and Means Committee that have jurisdiction over the basic tax legislation, who have been working with us since last year on the interrelationship between our housing programs and the tax measures and programs that impinge on housing. As a matter of fact, Representative Gephardt, has been working on this. So if there is no objection, we are going to see to it that they get this testimony so that we can be more specific as to how we can move as immediately as possible along that line.

I also want to mention that we have not had a member from Missouri on the subcommittee since that great lady, Leonor Sullivan, left us. You may know or may not that she was the ranking member of this subcommittee for 10 years when she retired voluntarily. But I also had the great honor of serving as the ranking member on the subcommittee that she chaired the longest, which was the Subcommittee on Consumer Affairs and Coinage, and the great landmark legislation, fair credit laws, not only for women, but I mean for consumer benefit, consumer credit beneficiaries, and we just have not had, to our loss, a Member from Missouri on this subcommittee, and it may not be the present delegation from Missouri's fault, because sometimes membership on this subcommittee gets hotly contested. This is the largest subcommittee in the whole Congress, 33 members. There are only 10 members of the full Committee on Banking that are not on this subcommittee. So thank you very much, Governor, and the two gentlemen with you that have taken this time and for giving us a very valuable presentation. It will be very helpful to us all.

Governor BOND. Mr. Chairman, we appreciate very much the kind and thorough hearing you have given us. You obviously have the benefit of the views of our Missourians, Representatives Emerson, Gephardt, and the others. Representative Dreier has a family in Missouri, so perhaps he can stand in as a Missourian.

As far as relations between Missouri and Texas, I know many Missourians went to Texas. At one time of stress, the State capital of Missouri was located in Texas. We are not in that difficult a shape at this point, but we extend our thanks for your hospitality as well as your understanding of our problems and your insightful suggestions on how to deal with them.

Chairman GONZALEZ. Thank you very much, gentlemen.

We have Hon. Joseph R. Paolino, Jr., member of the city council, Providence, R.I.

Councilman, thank you for being with us. Let me announce at the outset that your very great Congressman, a man we respect, had to go back to the district and wanted you to know that is the only reason he was not here to be with you.

STATEMENT OF HON. JOSEPH R. PAOLINO, JR., MEMBER OF THE CITY COUNCIL, CITY OF PROVIDENCE, R.I.

Mr. PAOLINO. Thank you for having me, Congressman Gonzalez and esteemed members of the Subcommittee on Housing and Community Development. I come before you today as a member of the Providence City Council in the State of Rhode Island, and as a lifelong resident of that State's capital city. I am grateful for the opportunity to testify at this hearing and to share with you the frustrations and concerns of my constituency.

As vice chairman of the Providence City Council's Committee on Urban Renewal, Development and Planning and as a member of its finance committee, I have become acutely aware of the detrimental impact that Reagan's budget cuts will have on Providence and the other older cities of the Northeast.

I am sure you are wondering what new wisdom I could p[illegible] bly contribute to the debate on the New Federalism. I am sure [illegible]

wondering what a local legislator from a city often identified as "the one you miss on Interstate 95 if you blink," can tell you about urban problems in Northeastern cities.

I think there is something important to be learned from Providence, because in many ways it typifies the older American city. We are an "economic-decline city," but we have by no means given up the struggle. We are a city of ethnic neighborhoods with people still willing to work for the public good. We are also a city that has been hurt by national economic trends. Providence is the archetype American city with the strengths and weaknesses that come from diversity and change.

In what specific ways have these trends been manifested? The population of Providence is now 156,804, according to the 1980 census. This constitutes a 12.5-percent decline since 1970. Our local economy has been dependent on manufacturing jobs which we are losing to the Sun Belt and overseas competition. Since 1970, the number of manufacturing jobs has dropped by 16 percent. We are a city that has been pushed to the brink of our fiscal limits. Over the last 10 years the amount of money paid in property taxes by our residents has increased by over 100 percent. We are struggling to keep industry and taxpaying homeowners in our city, to revitalize our deteriorating housing stock, and to spur development in our downtown business district. At the same time, we have tried to insure a decent quality of life for all those who reside in our city. We, too, support programs which aid the "truly needy," but many seem to be falling right through the gaping holes in the President's safety net. How can we stand by and watch our cities be destroyed and watch their residents suffer?

It is important to consider that Providence is not a city whose budget has ever been balanced by great infusions of Federal funds. In our fiscal year 1981 budget 61.8 percent of our revenue was derived from the property tax, 22.7 percent was provided by the State, and only 3.5 percent came from Federal aid. We are not asking the Federal Government to provide us with frills, nor are we coming to you for solutions to local problems It must be made clear that across-the-board cuts are not equitable and do not have across-the-board impacts. We in the Northeast will be subject to a disproportionate loss in aid. Members of Congress, the Reagan budget asks the local taxpayers, homeowners, and businessmen, to shoulder the burden of what should be considered national problems.

The New Federalism will only aggravate the problems of our already strained local tax base. If we choose to sustain all 43 programs that the President proposes to turn back to the States, we in Rhode Island will have to raise $61.6 million by 1984. This represents a 10.13-percent increase in State taxes. No State raises its tax rates easily, but it will be especially difficult in the Northeastern States and cities which are already experiencing severe fiscal difficulties. If propositions 13 and 2½ are any indication of how our constituents feel about property taxes, the prospects for these programs are extremely dim. No State or city in this Union, whether in the Sun Belt or the Snow Belt, can afford to take on dozens of new social programs without adequate Federal funding to go with them.

If we only consider the current level of funding, cities like Providence are not receiving their fair share of the Federal tax dollar. We are not a city that benefits from the proportion of the Federal budget that is spent on military contracts. Yet the funds we currently receive are critical for ensuring that our city does not slide into irreversible decline.

How does a city like Providence fit into the national agenda? We are not one of the 10 largest cities, so our problems may appear inconsequential when compared to those in New York City, Houston, or Los Angeles. Yet, at this congressional hearing it may be an advantage to be from Providence, R.I. All of you who represent districts from across the country may have a particularly difficult time justifying to your constituents expenditures that benefit cities like Chicago, Detroit, or New York. These cities are often dismissed as aberrations; their problems are considered different from those that exist in the average American city. Well, the vast majority of cities in this country are like Providence, and our problems may not be dramatic enough to command the attention of the national media, but they are just as real. My presence at this hearing is, in some sense, an attempt to broaden the concept of "urban issues," making it clear that small and midsize cities in this country are also suffering.

This hearing provides me with an opportunity to criticize Reagan's urban program, but I am also here to speak in support of H.R. 5731, Housing and Community Development, sponsored by Congressman Henry Gonzalez of Texas. This bill offers amendments to the Reagan budget which will authorize funds for single-family ownership stimulus and assistance, multifamily housing construction, and elderly housing assistance. I believe that H.R. 5731 provides a workable approach to continuing the revitalization of urban neighborhoods. We need these programs in Providence for low-interest mortgages in order to rehabilitate abandoned housing in neighborhoods such as Smith Hill, Elmwood, South Providence, Federal Hill, and Fox Point. And I can go on and on. We need funds that will reduce the cost of rental on cooperative housing for those whose incomes do not keep pace with inflation. Neighborhood revitalization benefits all residents of the city. It returns property to the tax rolls, it provides jobs in construction and related industries, and most importantly, it improves the quality of life for those individuals who remain committed to the city's survival.

I am particularly concerned about the elderly population in Providence, as is our Congressman St Germain. These individuals, who have contributed so much to our cities, must be assured that affordable and safe housing will be available to them. Also, the elderly who are on fixed incomes must be provided with the necessary assistance even when they choose to remain in their homes and 13.4 percent of Providence's residents are 65 or older. Demographers expect the number of elderly in our general population to continue increasing. The elderly will also be disproportionately concentrated in our central cities. Furthermore, the elderly in urban areas are more likely to be on fixed incomes. According to our most current statistics, in 1980, 34 percent of all elderly residents in Providence received some type of Federal housing subsidy. If t
1983 Federal budget is approved in its current form there

virtually no funds available for the new construction of subsidized elderly housing. I therefore applaud Congressman Gonzalez's bill for recognizing the needs of our elderly and for understanding that neighborhoods are the lifeblood of the city.

In the past, Federal funds have made the difference in the revitalization of many Providence neighborhoods. We have not created a total dependency situation, but rather have encouraged cooperative efforts between the community and State-level financing agencies. H.R. 5731 is particularly appealing because it offers flexibility to local governments in designing rental housing initiatives.

How can the current administration be so shortsighted in its policy objectives? Not only will the current budget cuts prevent future progress toward revitalization, but it will destroy the tenuous successes that we have already achieved. We all know how rapidly the contagion of housing abandonment spreads. In my own neighborhood of Federal Hill we have an old public school building that has been closed for 4 years. The building has been subject to repeated vandalism and fires. Why has this problem not been resolved when in this case the city has already sold the building to private developers for conversion into subsidized housing for the elderly? The answer should be obvious to this committee. This plan depends upon the continuation of HUD programs, and the private developers cannot move forward until their application is approved. This is not an isolated case. Ten public school buildings have closed in Providence during the past year. These buildings could remain community eyesores or they can be effectively recycled. This particular problem is occurring all over the country as our school-age population declines. Our need in Providence is elderly housing, but the conversion possibilities are endless. The Federal Government must continue encouraging innovation in housing rehabilitation, but with funds, not rhetoric.

There is considerable irony in the Reagan policy to cut funds for neighborhood revitalization. We in Providence have had clear successes using this evidence in the past and have designed programs that depend on the continued availability of Federal funds. We are particularly concerned about our borderline neighborhoods. Civic organizations, homeowners, and shopkeepers are willing to make the commitment. How can we, as public officials, not support their efforts when we know that Federal funds will make the difference between destruction and preservation.

Several neighborhoods in Providence provide stark illustrations of this progress. Elmwood is a neighborhood made up of diverse ethnic and economic groups. It is not severely deteriorated, though its housing has substantial need for rehabilitation. The programs in particular, stop wasting abandoned property and home improvement for Providence have had remarkable success in rehabilitating abandoned housing and in assisting low- and moderate-income families to bring their previously substandard properties up to city code enforcement standards. A mere $35,000 was sufficient to spur the rehabilitation of eight abandoned houses. Matching grants were also provided for historic preservation. All these successful efforts have depended on Federal funding. How can we cut off support just as these neighborhoods are beginning to show signs of rebirth?

We have other neighborhoods like Smith Hill and Fox Point which have large poverty populations and a deteriorating housing stock. We are beginning to make progress in Fox Point with a home improvement program, the neighborhood housing corporation, and special assistance for the elderly homeowner.

In the city of Providence, 52 percent of the housing units are considered substandard and 450 houses are lost to the market each year. But 50 percent of this abandonment is concentrated in neighborhoods like West End and Smith Hill. Federal assistance is crucial for their survival. Smith Hill is already in the early stages of revitalization, and the city estimates that its strategy to stabilize and upgrade the area will take another 6 to 9 years.

I will conclude by reaffirming my support for H.R. 5731. We need more funds available for low-interest mortgages, homeowner assistance, and land acquisition. The proposed Rental Housing Production and Rehabilitation Act of 1983 provides the logical role for the Federal Government. This bill will maximize local initiative while making it possible for cities to work with State finance agencies to produce affordable housing.

I ask that the Members of Congress put aside their partisan, sectional, and regional differences. I am not telling the poor and elderly in the city of Providence to pack up and move to Houston or Iowa. We in cities like Providence are confronting our responsibilities directly, and are committed to our families and neighborhoods.

Honorable Members of Congress, thank you for giving me this opportunity.

Chairman GONZALEZ. Thank you very much, Councilman. And particularly for your very strong and eloquent support of our bill. I, again, want to remind you that your Congressman and our very distinguished leader on this committee Mr. St Germain has really through the years been a leader and in the forefront of housing and community development legislation and is currently the standard-bearer for the leadership in this respect. Let me assure you that your Congressman and our chairman has familiarized us with Providence and what it has done. Let me tell you we are very much aware of Providence, and we are very grateful for the time you have given us, and I think really the basic question we would have you have answered in your testimony, and this is why I am so grateful for your strong endorsement of our bill. Does Providence have a section 312 rehabilitation program?

Mr. PAOLINO. Yes, sir.

Chairman GONZALEZ. On a previous occasion I believe we had the mayor—I do not know why, I was under the impression that last year during one of the hearings—it may have been Mr. Lynch—but in a question and answer I was sure that the city of Providence was mentioned as having had a section 312 rehabilitation program.

Mr. PAOLINO. Yes.

Chairman GONZALEZ. If you did not say so specifically, I gather that the impact of the administration's decision that whatever section 312 funds would remain or be recommended would be used for multifamily housing rehabilitation in fiscal year 1982—I gather that the impact there would be detrimental?

Mr. PAOLINO. Very much so, Congressman. There is no stimulus—or maybe that is the wrong word—there is nothing to attract people to move back into the urban cities. Many of them have left, and my testimony stated how we have lost a great deal of population just in 10 years. It seems that, unfortunately, the course of government is going higher. We are losing more people. We are losing our children who are going to school, but the cost of the school is going higher. To keep up on a city government when you have neighborhoods that are deteriorating, you need something to entice people to come back into the urban neighborhood, back into those neighborhoods that were once strong back in the early and middle 1900's and have now fallen aside.

Unfortunately absentee landlords have been moving in buying up these properties, bleeding these properties and bleeding the neighborhood, and we have to have something to entice the homeowners to come back, that yes, the cities are good to live in, safe to live in, and have what we need to have you stay in our city, whether it is Providence, Houston, New York, or what have you.

Chairman GONZALEZ. I notice in your statement a reference to the fact that you had had a great exodus of business and commercial activity to the Sun Belt. I come from the area that is designated as Sun Belt, and of course—let me put it this way—I was in elected public office 14 years before I was endorsed by any of the local daily newspapers, and then I did not have an opponent. So that what I am trying to say is that that gives you an idea of the relationship with what we call the establishment or power structure, and it is true to this day, and the reason is that, for instance, I saw the ads that the Chambers of Commerce were putting out, not only from my city but some State consortiums and Houston particularly in some of these slick magazines, and they were all based on an appeal to a cheap source of labor. We have no unions. In fact, one ad was boasting of the fact of the lack of union activity. And this was so horrendous to me. I was one of the local critics, and it seemed to me that it was self-evident that whatever business was attracted on that basis was illusory as to its lasting or permanent benefit, economic benefit. They are now finding it out.

One of the big stories in the paper about a week ago in my community was that the recession had finally caught up with the Sun Belt, and they mentioned specifically in our area the dismissal of about 200 employees, the curtailment of a bank of a neighboring town, one of the local establishments that seems to be the biggest employer in the civilian area. My city, unlike Houston, which you mentioned, and Dallas, it is a large city, but unlike the others, it does not have the type of industrial or business or economic base that say Houston or Dallas have, Dallas—Fort Worth. And yet, even in Houston the stories are coming out, in Dallas for some time. For instance, this week the Dallas paper had a report that their want ads in their paper were down almost 10 percent.

What I am saying is that the illusion of attracting economic activity from one region on to the other based on a dilution of standards, either labor standards or tax, for instance forgiveness of taxes and the like, it always seemed to me so self-evident that that was not the basis upon which to compete honestly and lastingly, and I regret that it seems to be coming out that way. So that I do not

know where your particular industrial activity went to—I can assure you it was not San Antonio—it might have been Houston. But we have—in the light of all this, we have, and we discussed it this morning—it came up when the Secretary appeared, because it is part of the program that the President and the administration, endorsed by the Secretary of HUD, are offering as a solution to this—known as the enterprise—business enterprise zone. Some say it is urban, some say it is urban and rural. In our part of the country, what we are afraid of is that what it means is bringing Nuevo Laredo north of the border, bringing Hong Kong to this country, and all these businesses that have fled and set up shop across the border, they are all based on that cheap labor, in fact, sweatshop labor, lower standards of pay, avoidance of tax responsibilities and the like. And to us this so-called urban enterprise business or rural enterprise business is just nothing more than bringing Puerto Rico to New York, Nuevo Laredo to San Antonio, Hong Kong to San Francisco.

This seems to be derogatory in view of the fact that our distinguished colleague, Mr. Garcia from New York is a coauthor, but I have said this to him and I have seen nothing so far in the legislation as suggested by the President in his message to us the other day that deters me from labeling it that way. It is all predicated on reduction of standards, whether it is local building codes or what have you, tax dodging, which is the only word I can think of for it. I am hopeful I am wrong again, but I see nothing in the awarding of the program as envisioned legislatively thus far that would cause me to say that as it stands now all it means to me is that we will just be bringing the shops from Nuevo Laredo maybe over to San Antonio.

I just wondered about some of the other programs that have not been mentioned. For example, what would be the impact on some of your ongoing commitments using community development block grants if the present rescission requests are honored? We are not talking about budgetary proposals. We are talking about the recission request that we are going to have to confront which would cut into 1982 funding. I would be interested in knowing what dependence Providence, for instance, in its basic rehabilitation approach has on community development block grants?

Mr. Paolino. I believe our budget for community development last year was close to $8.6 or $8.7 million that we in the city of Providence received. Next year's budget will be cut over $1.5 million in that program.

Chairman Gonzalez. That is about right. Let us see, 1 from 8—well, that translates fairly the percentage that we estimated.

Mr. Paolino. Now, community development is probably, in my opinion, a good program, and it is a good urban program. It is good for the neighborhood, and it is good for revitalization. It has done so much to help Providence, and eventually if these funds for community development are cut altogether, the decline of the neighborhoods is going to be so much greater than we could ever envision. People whose fuel per month is more expensive than their own rental for their dwelling—they have so many burdens on them now, the community development has been able to give them, give these people assistance in putting a new boiler in their home or

putting insulation in their home, because in the frost belt we have those high energy problems. So I could see if the cutting of community development continues and if it is bigger and greater and if it is ever phased out, the cities will be hurt drastically, and community development has done so much for historic preservation. In Providence we have so many beautiful structures, old structures of so much historic significance, and community development has offered a great deal to work along with the neighborhoods to bring some revitalization back into the individual neighborhood. So that scares me a great deal, when I hear that community development could possibly be phased out in the future.

Chairman GONZALEZ. Well, thank you very much, councilman. We deeply appreciate the time and effort and your testimony.

Mr. PAOLINO. Mr. Chairman, thank you.

Chairman GONZALEZ. I hope we will be able to have you up here again, but maybe perhaps under happier circumstances.

Mr. PAOLINO. It was an honor to be here and testify in front of you, sir.

Chairman GONZALEZ. Thank you very much.

Next, Dr. John H. Gibbons, from the Office of Technology and Assessment, its Director, and his very able assistant with him, and I will ask him to introduce her for the record.

Thank you, Dr. Gibbons, again, for the tremendous job that has been done by you and the Office. I think it has really been a valuable asset to the Congress, and I was here when it was initiated.

I had the privilege of voting for it and have always supported its appropriations and have always resisted the budgetary cuts, because the reports we received from your Office have been most helpful.

We haven't had a chance to evaluate the latest one, but it comes at a very opportune time because this was the subject matter of a letter that we just addressed to the President with respect to energy standards, building standards.

So welcome aboard and thank you very much.

STATEMENT OF DR. JOHN H. GIBBONS, DIRECTOR, OFFICE OF TECHNOLOGY ASSESSMENT, ACCOMPANIED BY MARY PROCTER

Dr. GIBBONS. Thank you very much for inviting us to be with you today. I am pleased to have with me the director of the study which I will report on today, Ms. Mary Procter, who very ably directed that work.

I will submit my statement for the record and proceed with a more summarized version.

We are releasing today a major report called "The Energy Efficiency of Buildings in Cities". This is the big fat version which has all the details.

There are also summaries available for you, sir. This study was originally requested by the House Committee on Banking, Finance and Urban Affairs.

With your permission, Mr. Chairman, I will submit a copy of the summary of this study to accompany my testimony.

Chairman GONZALEZ. Without objection, so ordered.

Dr. GIBBONS. The report deals with categories of buildings which together use about half of all the energy that was consumed in buildings in 1980.

This focuses on buildings that reside in cities: commercial buildings, multifamily buildings, buildings occupied by low-income people and single-family homes located in the central cities.

The findings of the report can be summarized in six points. But first, I would like to emphasize that the report and our study was concerned with the long-term increases in energy efficiency of our building stock.

We did not consider the transitory type cutbacks that can also occur in energy consumption in buildings. In monitoring the impressive drop that has occurred in our national energy [illegible] ratio, it is extremely important to distinguish the real gains in energy efficiency which are being made from the rather unhappy effects of economic recession and energy curtailments.

It is important to realize that careful energy-conscious design of new buildings can make an enormous difference in the amount of energy required to operate a building in [illegible] for a surprisingly small [illegible] change in the amount of construction cost.

Now the result is that one has a substantially lower total cost to both pay for the building and to operate it. This happens because the costs, for example, of added insulation in a new building are offset by the savings that come from needing smaller heating and cooling equipment.

In other words, it is critical to design buildings as [illegible] systems in order to minimize the total costs of these buildings.

The same reason also applies to retrofit of existing buildings [illegible] [illegible] under conditions of major renovation.

Two-thirds of all the buildings that are going to be in use at the turn of the century are standing today in our cities [illegible] the [illegible] area.

First, our study found that the largest part of [illegible] estimated [illegible] [illegible] [illegible] savings in the buildings [illegible] [illegible] with investments that have a [illegible] payback period of [illegible] years or less.

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

All of these owner types have good to excellent access to capital and professional property management services. We also estimated that moderate- and upper-income owners of single-family buildings and owner occupants of multifamily buildings and commercial buildings would invest in their buildings to a similar extent.

My third point, Mr. Chairman, which begins on the top of page 4, is that despite all of the activities stimulated by the market or by many local programs which are independent of the Federal Government, we found sizable gaps in the ability of the market itself to stimulate investment in energy efficiency.

The combined impact of the gaps in market stimulus could cause up to 4 of the 7 quads of potential energy savings to be foregone or lost because of failure to make investments in these energy efficiency opportunities.

Buildings are, by and large, owned by individuals and small partnerships. For several reasons, such owners are limiting their investments in energy efficiency to those which can be financed out of 1 or 2 or perhaps 3 years of projected energy savings.

The most important of these reasons is lack of access to long-term capital at reasonable rates.

Individuals and small partnership owners generally do not have good access to capital. Such owners only have access to loans of short terms and relatively high interest rates.

In addition, there is a substantial risk for owners of individual buildings that the energy savings will not come up to what was predicted.

What data exist that compare actual energy savings to the predicted energy savings show a very wide range of results. The range runs from 50 to 70 percent more savings than were projected to 50- to 70-percent savings below what was predicted.

That presents, of course, a very substantial risk. Now, one of the reasons for such poor predictability of energy savings is an inadequate data base on the outcome of actual retrofits to particular types of buildings, and this is particularly so for the larger buildings.

We identified several other categories of buildings whose owners are unlikely, given the present incentives, to make investments in improving the energy efficiency of their buildings.

These include owners of tenant-metered, multifamily buildings. The same seems to be true for retail buildings with net or pass-through leases, schools, and municipal buildings, low-income owners of houses, owners of low-rent, multifamily buildings, and I go into a further description of those owners in my written testimony.

I don't think I need to remind the subcommittee that the market forces have adverse effects in the absence of investments in energy efficiency.

Rising prices cause building owners to cut back energy use. Such cutbacks appear to be the cause of a large share of the increase of heating complaints in New York City, for instance, from 225,000 complaints in 1978–79, to 320,000 complaints in 1980–81.

As for means to address these problems, OTA found few private retrofit businesses that are able to assist in tapping capital re-

sources for building owners such as I described above, those that have relatively poor access to capital.

We found only one company that is putting up capital itself. We found opportunities, but few actual commitments for third-party financing of energy efficiency investments.

We found from our numerous interviews in our five-case study cities and other sources that cities in many regions find it difficult to free up financial and managerial resources for energy retrofit programs when so many other problems compete for the attention of city officials.

The fourth point is that the Federal Government housing programs have already had an impact on some of the kinds of building owners that we identified as otherwise unlikely to invest in their building's energy efficiency.

We assessed the impact of these programs through interviews and through the use of available program evaluations.

Let me mention the Federal programs, first, low-income weatherization. The 1981 weatherization budget was only about a tenth as large as the $1.8 billion spent for low-income energy assistance, that is for purchasing energy.

By late 1981, homes were being weatherized under the program at a rate of about 30,000 homes per months.

In other words, Mr. Chairman, we are paying out about 10 times more to help people get more dependent on subsidized energy purchases than we are in helping them become less dependent on energy itself.

We believe, Mr. Chairman, that the activity of the weatherization program could be doubled over several years to about 60,000 homes per month, a rate that would weatherize over a decade more than about half of the estimated 12 million poorly weatherized low-income homes, and that this would accrue at a cost of no more than 20 to 25 percent of the annual low-income energy assistance budget.

We also would like to emphasize that what is needed is long-lasting retrofits, not piecemeal measures such as taping thin plastic over windows, which doesn't last more than a season.

The second program is the housing rehabilitation programs, as I discuss on page 8 of my testimony.

We found that greater flexibility of housing rehabilitation programs is useful. The flexibility is useful for bringing about energy efficiency improvements when energy retrofit must be accompanied by basic repairs to the structures.

We found housing rehabilitation very helpful where major retrofits should be made, but the building owner needs reassurance that the neighborhood is sound enough so that the owner's investment can be recaptured when the property is sold.

This is why most cities concentrate rehab housing programs in specific neighborhoods, so the property owners know that the others are also investing.

This is another means of reducing the owner's perceived risk in making his investment. However, if housing rehab programs are to fulfill their promise as an effective means of increasing buildi energy efficiency, housing officials need to improve their techr' knowledge of energy efficiency mechanisms.

From the case studies and from information on housing rehab programs in other cities, we concluded that the biggest gap is in housing officials' knowledge of heating systems, especially in Northern cities.

My testimony beginning on page 9 contains some specific aspects of heating systems that these officials should be keeping in mind.

Finally, in terms of Federal programs on page 10, I mentioned public housing. Authorities in Jersey City and Buffalo, two of the five case studies we looked at, have made significant retrofits in projects using housing modernization funds.

However, we found that the identification of energy efficiency measures was somewhat haphazard.

It wasn't guided by a systemmatic or thorough energy audit procedure. The Ehrenkrantz report is a careful analysis of all the energy efficiency opportunities possible in major physical types of public housing.

The fifth of my six points is that there are several choices for further Federal involvement in stimulating investments in energy efficiency.

From the perspective of shaping the Federal role to one that complements efforts of the private sector, the obvious role for the Federal Government is to develop an economic situation and policy that will make it possible for longer term financing to become available at lower interest rates.

We believe this step can do as much as any other single thing in accelerating investment in greater energy efficiency. In view of continued national need for increased energy efficiency, Congress may also wish to consider making available temporary subsidies for energy efficiency investment loans.

I go into more detail on that in the testimony. I also provide several additional specific suggestions relevant to H.R. 5731 in my written testimony on page 11 and part of page 12.

An effective low-cost Federal role could also be to emphasize programs that lower the perceived risk of investing in retrofit. One critical need is for carefully designed verification of auditing techniques and the techniques of computerized analysis of buildings by comparing the theoretical results against the actual results that have been achieved by retrofit programs.

Since public housing is required to have energy audits before comprehensive modernization is implemented, it would be a straightforward task to compare energy savings predicted by audits with actual savings after a retrofit, and that information in turn could be helpful to similar activities that would follow.

A final comment, Mr. Chairman, continuity in Government policy toward energy efficiency is just as important in stimulating the marketplace as it is for any other aspect of Government economic policy.

The task at hand, which is to renovate our Nation's stock of buildings so that they are matched to the new cost of energy, is immense, but very important.

At the current rate of change, about 60 percent of the buildings in the year 2000 are already standing.

Well over a decade of hard and sustained work and a large amount of investment is required. Continuity of policy is essential, especially because much time and expertise and effort is required.

It is important to set sound policies, develop sound programs, and then give them sufficient time to take full effect.

Mr. Chairman, that completes my summary. Thank you for inviting us here today.

[Dr. Gibbons' prepared statement "Improving the Energy Efficiency of Buildings in Cities" and the referred-to summary report "Energy Efficiency of Buildings in Cities" follow:]

IMPROVING THE ENERGY EFFICIENCY OF BUILDINGS IN CITIES

Testimony of John H. Gibbons
Director, Office of Technology Assessment
Before Subcommittee on Housing and
Community Development
House Committee on Banking, Finance
and Urban Affairs
Hearings April 1, 1982
on H.R. 5731 Housing Act of 1982

Thank you for the opportunity to testify on energy efficiency and buildings, especially housing, at this hearing. The Office of Technology Assessment is releasing today a major report, The Energy Efficiency of Buildings in Cities, which was originally requested by the House Committee on Banking Finance and Urban Affairs. I am here to present the report's key findings. With your permission I will also submit a copy of the report's summary for the record. The report deals with categories of buildings which together used about half of all energy used by buildings in 1980 -- commercial buildings, multi-family buildings, buildings occupied by low-income people and single-family homes located in central cities. Most of the rest of building energy in the U.S. is used by single-family homes outside central cities. Prospects for energy conservation in these buildings were dealt within an earlier OTA report, Residential Energy Conservation.

The findings of the report which are relevant to the development of housing policies and programs can be summarized in several major points. Before proceeding, I would like to emphasize that the report is concerned with long-term increases in the energy efficiency of the building stock not with transitory cutbacks in response to higher energy prices.

1. We estimate the major part of an estimated potential seven Quads* of annual savings from increased energy efficiency in these categories of buildings can be achieved with investments with a simple payback in seven years or less. This can lead to a significant reduction in the energy costs of most types of buildings. In our recent assessment we analyzed thirteen different building types with significantly different retrofit options. For each of them there are a large number of effective, proven investments which can reduce energy use. Details can be found in the report's summary.

There are many reasons why it is in the national interest that our response to higher energy prices be in the form of investment in increased energy efficiency rather than in the form of cutbacks and curtailments in energy use. I would like to remind you of these reasons. One is that when energy efficiency improvements are embodied in the building stock, they will survive several building owners and assure a long-term level of energy demand for which suppliers of energy can plan. A second reason is that increased energy efficiency instead of cutbacks increases our resilience to further price shocks or disruptions when cutbacks become necessary. If cutbacks are our chief response to higher prices now, then we have played our last card and have no more cards to play.

2. There is no doubt that market forces are bringing about a significant fraction of the savings potential in buildings which we identified. We estimate that about 3 quads per year of the estimated 7 quads per year in savings potential will result from investments in greater building energy efficiency in response to higher energy prices.

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* Seven Quads equals 3.5 million barrels of oil per day for a year.

From interviews with almost one hundred owners of multi-family and commercial buildings we concluded that certain categories of owners have already or definitely will retrofit their buildings. These owner types include institutional owners such as insurance companies or pension funds, corporations which occupy their buildings and nationally syndicated partnerships. Owners in these categories that we interviewed had explicit policies of making energy efficiency investments and set explicit payback criteria ranging up to three to seven years. Many had already retrofit their buildings. All of these owner types have good to excellent access to capital and professional property management advice. All have a long-term investment perspective on their buildings. As the head of a national syndicate's property management department explained to us, "The sophisticated investors we deal with want quality in their product not just [tax] shelter."

We also estimated that moderate and upper-income owners of single-family buildings and owner-occupants of multi-family buildings and commercial buildings would invest in their buildings to a similar extent.

In response to these market opportunities, we found private sector retrofit companies very active in some parts of the country. Such companies primarily serve upper-income homeowners and businesses who have good access to capital. Utilities in some regions have developed active building retrofit programs, on their own or in response to state directives, as an alternative to further construction of high-cost powerplants. Finally cities in some regions have launched public-private retrofit programs involving banks, utilities and some public funding.

3. <u>Despite all the activity stimulated by the market or by some local programs which are independent of the Federal government, we found some sizable gaps in the ability of the market to stimulate investment in energy efficiency</u> (as opposed to further curtailments). The combined impact of the gaps in market stimulus could cause up to four Quads of energy savings per year (about 60% of the potential) to be foregone because of failure to make investments in energy efficiency.

Buildings are by and large owned by individuals and small partnerships. For several reasons such owners are limiting any investments in energy efficiency to those which can be financed out of one, or two, years of projected energy savings. The most important of these reasons — and one that is all too familiar to members of this committee — is lack of access to long-term capital at reasonable rates. Individuals and small partnership owners generally do not have good access to capital. Currently, such owners only have access to loans of short terms (less than two years) and high interest rates (two points above prime). Debt service on loans for any retrofit with a payback longer than a single year could cut deeply into a building's cash flow. Many building owners cannot afford debt service that is not directly offset by energy savings. As one multi-family building owner in Buffalo told us, "I would normally want to spend $5,000 in order to save $2000 [per year] but not when I can't afford [debt] service on the $5,000."

In addition there is a substantial risk for owners of individual buildings that energy savings will be below what has been predicted. What data exists comparing actual energy savings to predicted savings shows a range of results from savings that are 50%-70% <u>above</u> predicted to 50%-70% <u>below</u> predicted. There is therefore a substantial risk that a retrofit predicted to

have a three year payback could end up with a six year payback instead. Under such conditions energy savings will not nearly offset debt service costs at current interest rates. One of the reasons for such poor predictability of energy savings is inadequate data on the outcome of actual retrofits to particular types of buildings, especially data that take into account such important influences on energy savings as climate variations from year to year, occupant changes, occupant behavior and the effect of previous retrofits.

We identified several other categories of buildings whose owners are unlikely, given present incentives, to make investments in improving their energy efficiency. Owners of tenant-metered multi-family buildings have little incentive to make their buildings more energy efficient. There is little evidence that an energy efficient building can charge higher rents for space that is similar in amenities to other less energy efficiency space. The same seems to be true for retail buildings with net or pass-through leases in which the tenants pay for maintenance and utilities. Only in fairly soft markets for office buildings did building owners tell OTA that they would expect tenants soon to start looking at the escalator clauses and the typical utility costs of the building as well as the quoted rent.

Schools and municipal buildings are another category of buildings where energy investments are likely to be made slowly or not at all. School boards and municipal governments share with corporations and insurance companies the characteristic that they have annual planning and budget cycles and professional property management. Unlike the corporate or large institutional owner, on the other hand, government owners of buildings have severe constraints on substituting capital for operating expenses due to severe pressures on annual budgets (especially in times of subtantial inflation). In addition, there are many limits on bond market access and use.

Low income owners of houses have very strong incentives to cut back on energy use but few means to make effective energy investments. From an analysis of costs and expense for several prototypical multi-family buildings we concluded that owners of low-rent multi-family buildings would benefit most from energy retrofit because energy is such a big fraction of their cost. Owners of such buildings, however, find it especially hard to obtain capital to invest. Furthermore, such owners often fear that they will be unable to recover the cost of the retrofit when selling the building if it is located in a marginal neighborhood with uncertain housing values.

I would like to remind the subcommittee that market forces have effects in the absence of investments in energy efficiency. Rising prices cause building owners to cut back energy use. Such cutbacks appear to be the cause of a large share of the increase in heating complaints in New York City from 225,000 in 1978-79 to 320,000 in 1980-81. In one of its case studies OTA found that city officials were very concerned about landlords' inability to pay rising energy costs. A housing official in Jersey City explained, "The smaller landlords are well in over their heads already and do not know how to cope. They sell out to the large absentee owners who cut services and the good tenants move out." Owners of multi-family buildings also respond, where it is technically and financially possible, by installing tenant-metering. This is a capital investment the primary impact of which is to encourage tenants to curtail energy use. Tenant-metering eliminates any incentive for the landlord to increase the energy efficiency of the building.

As for means to address these problems, we found few private retrofit businesses able to assist in tapping capital resources for building owners without their own access to capital. We found only one company that is

putting up the capital itself. We found opportunities but few actual committments for third-party financing of energy efficiency investments.

We also found that many private utilities are constrained by their particular financial circumstances or by state regulatory practices from launching anything but small-scale audit programs to improve customer relations. We found from our interviews in five case study cities and other sources that cities in many regions find it difficult to free up financial and managerial resources for energy retrofit programs when so many other problems compete for the attention of city officials.

4. The Federal government housing programs have already had an impact on some of the kind of building owners we identified as unlikely to invest in their building's energy efficiency. We assessed the impact of these programs through interviews in five case study cities and through use of available program evaluations. In general programs required some improved management but were structured to have beneficial effects. Let me mention these programs briefly.

Low-income weatherization. The 1981 weatherization budget was only about one-tenth as big as the $1.8 billion spent for low income energy assistance. By late 1981, homes were being weatherized under the program at a rate of 30,000 per month. The program had improved its workmanship and quality control and had begun to reach more rental properties. It was well administered in some states. We believe that the activity of the program could be doubled over several years to 60,000 homes per month, a rate that would weatherize over a decade more than half of the estimated 12 million poorly weatherized low-income homes at a cost no more than 20%-25% of the annual low income assistance budget. We would also like to emphasize that

what is needed here is

measures such as plastic storm windows t last no more than a season.

Housing Rehabilitation Programs. We found that greater flexibi

housing rehabilitation programs is useful for bringing about energy improvements in two kinds of situations. One is when energy r t accompanied by basic repairs. Half of the approximately five million units defined as most energy-inefficient in a recent HUD ε classified as structurally inadequate (which means that they h of a long list of major defects). We encountered this sit : case-study cities -- in Buffalo where 142,000 out of 166,000 l were built before 1939, and in San Antonio where 27% of the hous: in city is defined as substandard according to city rehabilitation officials.

A second situation is where major retrofits should be made but the building owner needs reassurance that the neighborhood is sound enough that the owners's investment will be recaptured when the property is sold. Most cities concentrate housing rehabilitation programs in specific neighborhoods so that property owners know that others are investing. Cities often upgrade such neighborhood amenities as sidewalks at the same time. This is another way to reduce the owner's perceived risk of retrofit.

In some cities such as Boston and Pittsburgh housing rehabilitation funds from Community Development Block Grants (CDBG) are being used for fairly large-scale energy retrofit, affecting hundreds of building owners each year. In other cities, energy retrofit measures are included in general building rehabilitation packages.

However, if housing rehabilitation programs are to fulfill their promise as an effective means of increasing building energy efficiency, housing officials need to improve their technical knowledge of energy efficiency improvements. From the case studies and from information on housing rehabilitation programs in other cities we concluded that the biggest gap is in housing officials' knowledge of heating systems especially in Northern cities. Specifically, housing officials should incorporate the following into their rehabilitation programs:

a. A 20-30% increase in the efficiency of a heating system can have as powerful effect on the energy costs for a household as a 20-30 % reduction in heat loss due to wall or attic insulation or storm windows.

b. Hot-air furnaces and steam or water boilers should be individually tested for their efficiency of operation. The efficiency of many furnaces and boilers can be greatly increased through inexpensive or moderately costly means that fall far short of replacing the entire heating system. These means range from simple adjustments to heating system controls to replacing the burner.

c. Heating systems are often oversized for the heating load they must meet and therefore remain off for long periods in order to avoid overheating the living space. This reduces the efficiency of the heating system, which is usually highest in more continuous operation. This common problem is exacerbated when improved insulation reduces a building's heating load still further. A properly sized heating system can often be significantly smaller than standard practice for that building type. This saves money both on energy (because efficiency is maximized) and on the cost of the heating system itself.

Through technical assistance to housing programs and continued monitoring of the best energy efficiency practices, the Federal government should insure that housing rehabilitation incorporates the latest and best in energy efficiency techniques.

Public Housing. Public housing authorities in Jersey City and Buffalo of the five case study cities, had made significant retrofits in some projects using modernization funds. As with housing rehabilitation programs, however, we found that the identification of energy efficiency measures was somewhat haphazard and not guided by a systematic and thorough energy audit procedure. The published (in March 1980) but not yet distributed Ehrenkrantz report* is a careful analysis of all the energy efficiency opportunities possible in the major physical types of public housing. It gives a clear blueprint for proceeding. Making available adequate modernization funds for energy retrofit helps alleviate the income-expense squeeze which is as severe in public housing as in private low-income housing.

5. There are several choices for further Federal involvement in stimulating investment in energy efficiency. From the perspective of limiting the Federal role to one that complements efforts in the private sector, the obvious role for the Federal government is to develop an economic policy that will make it possible for longer-term financing to become available at lower interest rates. We believe this step can do as much as any other thing in accelerating investment in greater energy efficiency.

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* An Evaluation of the Physical Condition of the Public Housing Stock. H-2850, March 1980, by Perkins and Will and The Ehrenkrantz Group for the Department of Housing and Urban Development. Also Energy Conservation Handbook, October 1980.

In view of continued national need for increased energy efficiency, Congress may also wish to consider making available temporary subsidies for energy efficiency investment loans, through mechanisms such as the Solar and Conservation Bank, until interest rates come back down to some specified level. Lengthening the term of available loans (through loan guarantees, creation of secondary markets or other means) can be as important than lowering the interest rate. It would also be useful to make long-term property improvement loans (which can be used for energy retrofit) available through CDBG. HUD's pilot program in 25 cities to use CDBG for multi-family property improvement loans is a step in the right direction.

In the legislation you have before you, Congress might consider making explicit reference to energy efficiency improvements as part of the proposed $1.3 billion program for multi-family production and rehabilitation. The least cost criteria for project selection in Section 314 (5), for example, could be modified to include reasonable projections of future utility costs for the building so that the Federal government does not encourage the production of "least-cost" housing with "most-cost" operating expenses due to energy inefficiency. Suitable language has been used in the existing regulations for both the Section 312 rehabilitation programs and in Section 8 housing programs and could be adapted for this purpose.

In authorizing $1.7 billion for public housing modernization, Congress may wish to assure that the responsibility is taken seriously to substantially upgrade the energy efficiency of public housing, for example by making maximum use of existing technical analyses of retrofit techniques for public housing and of the requirement for an energy audit as part of a comprehensive modernization plan. Public Housing Authorities could be given incentives to

retain part or all of the savings in energy costs, perhaps in the form of a reserve for further energy conservation improvements.

Congress might also consider explicitly permitting some use of the $770 million designated for Section 202 elderly and handicapped housing loans, for energy efficiency upgrading of buildings originally financed in this way. At an interest rate of 9 1/4 percent, many energy retrofits will pay their way with savings in energy cost.

In these times of budgetary constraint, an effective Federal role could also emphasize programs to lower the perceived risk of retrofit. One need is for carefully-designed verification of auditing techniques and of techniques of computerized analysis of buildings by comparing theoretical results against actual results of retrofits in buildings. Several housing programs lend themselves nicely to this. The most obvious is the public housing modernization program. Since public housing is required to have energy audits before comprehensive modernization is implemented, it would be a straightforward task to compare energy savings predicted by audits with actual savings after a retrofit. These results could be compared for a particular type of multi-family building, such as masonry rowhouses with gas space heaters. Documentation of actual retrofits could also be built into some Community Development Block Grant rehab programs, especially those focussing primarily on energy retrofit.

6. I have one final comment. Continuity in government policy towards energy conservation is just as important in stimulating the free market as it is for any other aspect of government economic policy. As has been said many times consistency of policies and programs is at least as important as the specific content of the policies themselves. Rapid changes in energy programs

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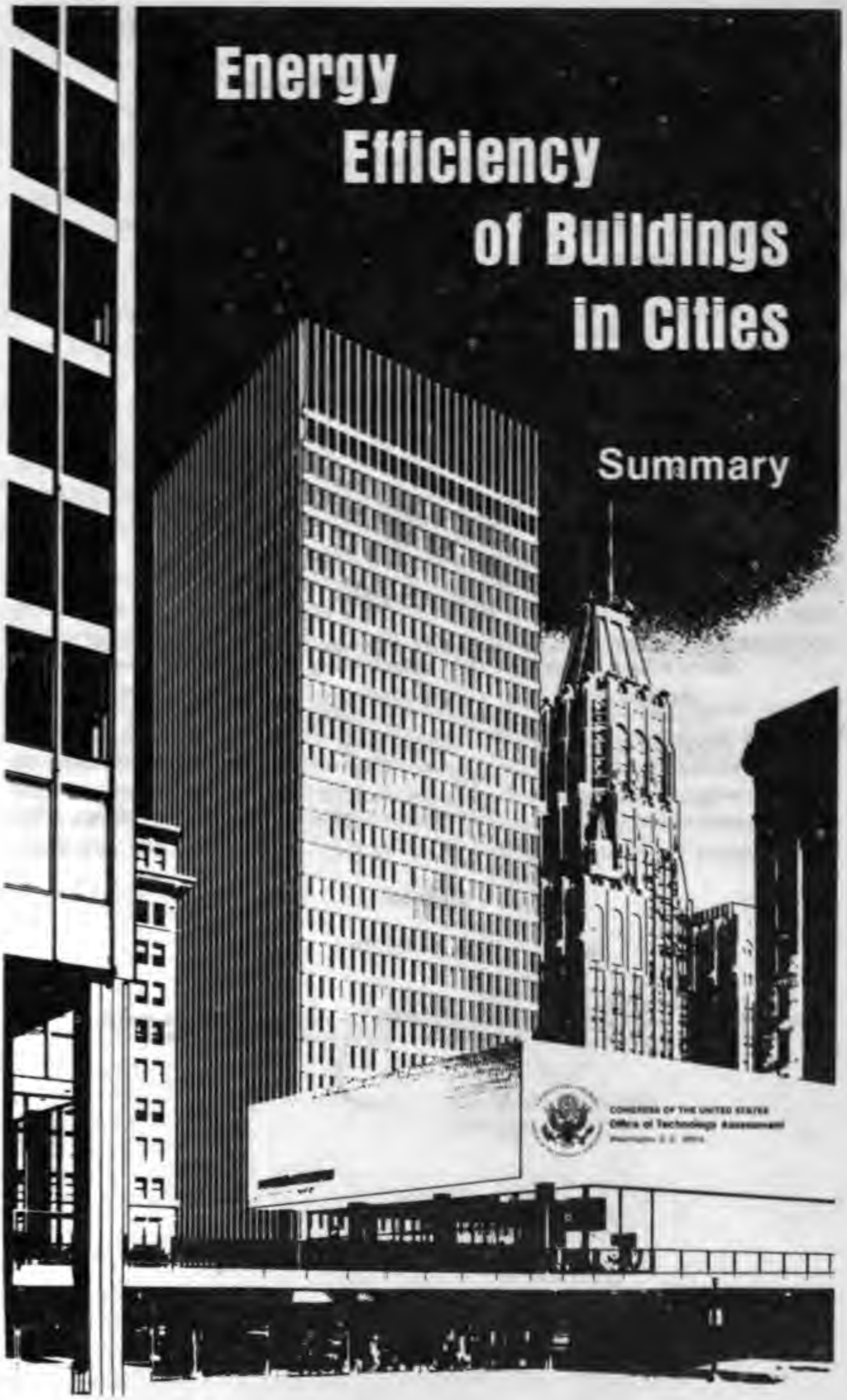
may be necessary to accommodate changes in political context but their cost should be well understood. Business make investments looking several years ahead. Businesses and governments staff, train, and manage based on accumulated experience from successes as well as problems. Since the weatherization program is addressed in the proposed legislation, we would like to express our concern that another shift from DOE back to HHS may be unfortunate. In our interviews in the five case study cities we were told of the confusion caused by the last shift of weatherization -- from CSA to DOE -- in training, technical assistance and even the mechanics of contracting and accounting. To cycle the responsibility again will surely undermine the program's effectiveness.

The task at hand -- to renovate our nation's stock of buildings, so that they are matched to the new cost of energy, is immense but very important. At the current rate of change, about sixty percent of the buildings in the year 2000 are already in existence. We must take care that these buildings still serve us. Well over a decade of hard sustained work and a large amount of investment is required. Continuity of policy is essential especially because much time, expertise and effort is required. It is important to set sound policies and develop sound programs and then give them sufficient time to take full effect.


Energy
Efficiency
of Buildings
in Cities
Summary
CONGRESS OF THE UNITED STATES
Office of Technology Assessment

Office of Technology Assessment

Congressional Board of the 97th Congress

The Technology Assessment Board approves the release of this report The views expressed in this report are not necessarily those of the Board, OTA Advisory Council, or of individual members thereof.

Foreword

This summary presents the major findings of an assessment requested by the House Committee on Banking, Finance, and Urban Affairs for an evaluation of the impact on buildings found in cities, of energy price increases, and of Federal policies to encourage energy efficiency and the use of renewable energy in buildings. By focusing on multifamily and commercial buildings the report complements an earlier OTA study, *Residential Energy Conservation,* which analyzed the potential for improved energy efficiency of single-family houses.

In the assessment, OTA examines the potential for increased energy efficiency in buildings found in cities from two perspectives: that of the energy expert who assesses technical opportunities for improved energy efficiency, and that of the real estate expert who evaluates the financial attractiveness of real estate investment opportunities. OTA categorizes existing buildings according to their technical retrofit potential and also groups building owners according to the likelihood that they will invest in retrofits. The report assesses the prospects for large-scale stimulus of building retrofit by private businesses, public utilities, and city and State governments. Several options for Federal policies towards building retrofit are provided. The study also includes an analysis of the technical and economic feasibility of district heating in cities.

We are grateful for the assistance of the project advisory panel, as well as for the background work done by several contractors and the advice of numerous reviewers in State and local governments, universities, public interest groups, and business. It should be understood, however, that OTA assumes full responsibility for this report which does not necessarily represent the views of individual members of the advisory panel.

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Energy Efficiency of Buildings in Cities

SUMMARY OF FINDINGS

Overview

This study is concerned with the prospects for and barriers to increased energy efficiency in the building stock of the Nation's cities. From the perspective of the energy specialist, the report assesses the specific capital investments that might be made to make existing buildings more energy efficient. Then from the perspective of the real estate specialist, the report identifies which of these investments in energy efficiency are likely to take place and which are not, and why.

Overall, OTA estimates that about 7 Quads* per year of energy savings is technically possible by 2000, through feasible** investments in the improved energy efficiency of building types covered in this report (see table 1). Nearly 3 Quads of these potential energy savings are likely to come about because of investments in energy efficiency made by building owners who have personal or business reasons to invest money in improved energy efficiency of their buildings.

The other 4 Quads of potential energy savings, on the other hand, may not occur because building owners fail to make investments in the energy efficiency of their buildings. Part of the failure to retrofit is due to the difficulty and costliness of improvements in energy efficiency to some building types. Part of the failure is due to building owners' stringent requirements for return on investments in energy efficiency. The diversity of buildings and owners and their implications for national energy use is described below.

*A Quad equals a quadrillion Btu of energy, a very large unit of energy. It is equivalent to about 500,000 barrels of oil per day for a year, or about 50 million tons of coal, or the output of 18 1,000-MW powerplants at average utilization. Seven Quads is equivalent to the energy of more than two-thirds of the oil the United States imported in 1981.

**Feasible investments are defined as those which in 1981 are technically feasible and which would be cost effective over a 20-year lifetime, assuming no real increases in energy prices and a 3-percent real return on investment.

BUILDING BY BUILDING RETROFIT POTENTIAL

Technical Description

The national potential (estimated in table 1) for increased energy efficiency of the building stock is the result of physical changes to improve the energy efficiency of millions of buildings. For convenience, these physical changes are referred to as *energy retrofits* in this report. While recognizing that each building is to some extent a unique problem, OTA did identify the major characteristics of buildings which influence the types of energy retrofits that are likely to be most effective. These are:

- **Size.**—Energy retrofits which improve the energy efficiency of the building envelope (walls, windows, and roof) are more important for small buildings than for large buildings. On the other hand, certain kinds of retrofits which bring about similar savings in small buildings and large buildings will cost relatively less per unit of energy saved in large buildings because of economies of scale.
- **Wall and roof type.**—Masonry or curtain walls and flat roofs without attics or with very small crawl spaces are much more difficult to insulate than are wood frame walls and roofs with attics and ample crawl spaces.
- **Mechanical system (HVAC) type.**—Physical changes to the way space heating or cooling is produced and circulated can provide significant increases in building efficiency but vary with the type of heating ventilation and air conditioning (HVAC) system used by the building.

Table 1.—The Gap Between Likely Energy Savings Through Retrofit and Technically Feasible Savings by the Year 2000: Building Types Covered in This Report (quadrillion Btus of primary energy)

	Projected energy use[a]	Technical savings potential[b]	Likely savings[c]	Gap: technical savings potential not realized
Multifamily buildings (all)	2.4	1.0	0.3	0.7
Commercial buildings (all)	6.3	3.5	1.3	2.2
Low income single family (all)	1.6	0.8	0.2	0.6
Moderate and upper income single-family homes in cities	3.5	1.8	0.9	0.9
Total buildings covered in this report	13.8	7.1	2.7	4.4

[a]Projected energy use in 2000 assumes no reduction from current energy use by these buildings and is based on a set of assumptions, that are described in the appendix to ch. 2, about demolition of existing buildings and construction of new buildings needing retrofit. A quadrillion Btu equals approximately 5000,000 barrels of oil per day for a year.

[b]The technical savings potential is defined as that resulting from all retrofits to these building types which as of 1981, are technically feasible and which would be cost effective over a 20-year lifetime, assuming no real increases in energy prices and a 3-percent real return on investment.

[c]Likely savings are those which are likely to come about from investments by building owners under current conditions of availability of capital, retrofit information, and public programs.

SOURCE: Office of Technology Assessment.

- **Building use.**—Most *commercial buildings* are used from 9 to 5 on weekdays (offices) or 9 to 9 daily (shopping centers) and are unoccupied outside these hours. This provides opportunities for improved energy efficiency by careful control of temperature and lighting between operating and nonoperating hours. Opportunities also exist for more efficient and task-specific lighting in commercial buildings. Finally, retrofits to the hot water system of *multifamily buildings* can usually save considerable energy.

Capital Costs

OTA reduced 43 potential combinations of the four building characteristics described above to 13 building types for which the lists of appropriate retrofit options are distinct (although there may be considerable overlap among them). The 13 building types are shown in table 2. **OTA identified no major category of building typically found in cities for which substantial savings were not available from retrofits of low or moderate capital cost compared to savings.**

For some of the building types, a major part of the potential savings are likely to come from retrofits of low capital cost compared to savings (see table 3) in the sense that they will pay for themselves in energy savings in 2 years or less and will earn real rates of return over the life of the retrofit (20 years on average) of more than 50 percent per year

Table 2.—Thirteen Types of Buildings With Significantly Different Retrofit Options

Building type and wall type	Mechanical system type	More energy savings from: Low capital cost[a] retrofit package[a]	Moderate capital cost[a] retrofit package[a]
Small house with frame walls (single family or 2-4 units)	Central air system	X	
Same	Central water system[b]	X	
Same	Decentralized system	X	
Small rowhouse with masonry walls (single family or 2-4 units)	Central air system		X
Same	Central water system		X
Same	Decentralized system		X
Moderate or large multifamily building (masonry or clad walls)	Central air system	X	
Same	Central water system	X	
Same	Decentralized system		X
Moderate or large commercial building (masonry or clad walls)	Central air system	X	
Same	Central water system		X
Same	Complex reheat system	X	
Same	Decentralized system	X	

[a]See table 3 for a definition.
[b]OTA's assumption is that this building type has a central water system and window air-conditioners.
SOURCE: Office of Technology Assessment.

Table 3.—Three Ways to Express the Relative Cost Effectiveness of Energy Retrofits

Relative capital cost[a]	Simple payback[b] (in years)	Annual real return on investment[c] (percent)
Low capital cost[d]	Less than 2 years	More than 50% per year
Moderate capital cost[d]	2 to 7 years	13 to 50% per year
High capital cost[d]	7 to 15 years	3 to 13% per year
Cost of retrofit exceeds savings[e]	More than 15 years	Less than 3% per year

[a] See ch. 3 for a full definition. Low capital cost is defined as less than \$14.00 per annual million Btu saved. Moderate capital cost is defined as \$14.00 to \$49.00 per annual million Btu saved. High capital cost is defined as \$49.00 to \$105.00 per million Btu saved. In all OTA's calculations in ch. 3, all electricity savings are multiplied by 2.46 to reflect the higher cost of electricity.
[b] Annual real discount rate that equates costs and savings over a 20-year measure lifetime. This assumes that fuel savings escalate at the same rate as inflation.
[c] Number of years for value of first year's energy savings to equal retrofit costs. Assumes value of energy savings is \$7.00 per million Btu (approximately equal to the average price of distillate fuel oil in 1980).
[d] Compared to savings.
[e] Not cost effective.

SOURCE: Office of Technology Assessment.

assuming no increase in the real cost of energy. These building types include all small frame houses, moderate or large multifamily buildings with central air or water mechanical systems, and all commercial buildings except the usually older commercial buildings with water or steam heating systems and window air-conditioners. Clearly the problem of financing retrofits for these buildings should be minimized by the fast payback (and high return) of their retrofit options. Some of these fast payback retrofit options include wall insulation in frame buildings, economizer cycles which make greater use of outside air for air-conditioning in commercial buildings and hot water flow restrictors in multifamily buildings.

For all of the remaining building types, on the other hand, substantial savings are more likely to come from retrofit options of moderate capital cost compared to savings, which will payback in 2 to 7 years and whose real rate of return can range from as high as 50 percent to as low as 13 percent per year over a 20-year retrofit life (also see table 3). These building types include all small masonry rowhouses, moderate or large multifamily buildings with decentralized heating and cooling systems, and older commercial buildings with water or steam systems and window air-conditioners. For owners of such buildings there may be significant problems of financing substantial energy retrofits. Some examples of effective retrofits with moderate capital cost include: roof insulation and storm windows for masonry rowhouses, hot water heat pumps for multifamily buildings with decentralized systems, and replacing low efficiency window air-conditioners with more efficient models.

For most of the building types there are also retrofit options of high capital cost compared to savings with paybacks of longer than 7 years and annual real rates of return of less than 13 percent per year (over 20

years). If lifecycle costing is used, such retrofits may in fact be less expensive over the full life of the measure of the cost of the energy they would save. However, their very slow payback and low annual rate of return create serious financing obstacles. **For most of the building types OTA examined, such high cost retrofits would save no more than 20 percent of the full technical savings potential.** The three exceptions and the estimated percentage of total savings from high cost retrofits are:

- Masonry rowhouse with a heating system using air (40 percent).
- Masonry rowhouse with a water or steam system (25 percent).
- Large multifamily building with an air system (30 percent).

Examples of some high cost retrofits which produce substantial savings in certain building types include: wall insulation in masonry rowhouses and multifamily buildings and night-time window quilts in multifamily buildings.

Importance of Solar Retrofits

Passive and active solar system retrofits can reduce the energy requirements for space heating and hot water just as nonsolar energy retrofits can. OTA compared costs and energy savings of seven different kinds of solar retrofits to small and large residential building types. Many solar retrofits are of high capital cost (slow payback and low return on investment); a few are of moderate capital cost and none are of low capital cost. For all building types and retrofits examined there are nonsolar energy retrofits which save as much and cost the same or less. If chosen strictly on the basis of capital cost and effectiveness, the nonsolar retrofits would probably be chosen first, although there are many reasons including esthetic ones for choosing solar retrofits. Some cost-effective solar retrofits on some building types are identified in chapter 3.

THE DIFFICULTY OF PREDICTING THE OUTCOME OF A RETROFIT TO A PARTICULAR BUILDING

While the general prospects for cost-effective retrofit are good they may be very unpredictable for particular buildings. Extensive research and applied work on the retrofit of buildings to improve energy efficiency has only been underway for the past few years and most of this work has focused on single-family housing. **There are little data on the actual effects of building retrofits, and for some types of buildings there are almost no data.** Few energy auditors or building owners have maintained and made available careful records of preaudit fuel consumption, cost and type of retrofit, and postretrofit performance. A recent compilation of data on actual retrofits of commercial and larger multifamily buildings (see ch. 3) included data on 222 buildings. Among these, there was only one multifamily building, one shopping center, and four hotels. Most of

the rest were schools and office buildings. **These data on actual retrofits confirm that, on average, considerable savings are possible from low and moderate cost retrofits.** For almost 90 percent of the buildings surveyed with good cost data available, the cost of the retrofit package installed paid back in energy savings in 3 years or less.

However, actual savings may be considerably higher or considerably lower than predicted for individual buildings. For the 60 buildings with data on savings predicted by an audit as well as actual savings achieved by the retrofit, actual savings varied in both directions (*more* than predicted and *less* than predicted) by a wide margin. For a group of 18 similar community centers, for example, actual energy savings averaged 85 percent of the predicted amount but varied (within one standard deviation) from 50 percent *more* than predicted to 80 percent *less* than predicted. Such results are only suggestive. Carefully designed data collection would be necessary to estimate more accurately the predictability of energy savings from different combinations of retrofit measures. The available data, however, are consistent with OTA's finding that there are inherent characteristics of building retrofit which are responsible for the substantial variation of likely savings from a particular retrofit from the predicted value. The variability can be reduced from its present level but it will probably remain substantially above zero.

Each structure is a unique combination of design, siting, construction, and previous retrofits. The behavior of the building occupants and the climate will also affect energy savings in unpredictable ways. These factors make it difficult to gather consistent data to determine the actual (compared to the theoretical) results of retrofit. Buildings with the same generic design will use energy differently due to the location of the structure in relation to the Sun. Further, buildings tend to vary in construction, even given the same design. Substantial amounts of energy can be lost through openings in interior walls, through leaky duct systems, and in other ways not obvious to the observer.

While there are methods commonly used to calculate heating loads, cooling loads, and other factors, these formulas best apply to a controlled situation rather than a real structure. As each energy retrofit is added to a structure, the system is changed, and very little is known about how to predict the interaction of several retrofits on a given building. Differences from building to building in the number of occupants and their living and working patterns (e.g., open windows v. air-conditioning) complicate the issue. In addition to behavior, microclimates and yearly weather changes will affect the actual amount of energy used. Thus, a researcher trying to figure out the real building energy use in a multifamily structure needs to know vacancy rate and local weather conditions that year as well as fuel use. Not all data are corrected for climate, and not all climate correction techniques are the same. It is even less common for data to be corrected for occupancy. The variation in data adds to uncertainty.

In many buildings increased energy efficiency depends heavily on building operation and maintenance. Some of the buildings described in

the survey above failed to save as much energy as predicted because of poor performance by the equipment operator. For larger buildings, systematic improvements in operation and maintenance are likely to save as much or more energy as capital investment. An energy auditor can recommend these changes in practice but they are not permanent improvements and will affect the degree to which actual savings match predicted savings.

WILL OWNERS OF CITY BUILDINGS INVEST IN THE ENERGY EFFICIENCY OF THEIR BUILDINGS?

Given an investment with a probable high return but a possibility of partial or complete failure (as well as a possibility of greater-than-expected success), how are the owners of buildings in cities likely to respond to the opportunities to increase the energy efficiency of their buildings?

Energy is now important. After many years of energy price increases the cost of energy is now sufficiently important for building owners in the balance of income and expense of their buildings that steps have to be taken to control it. This is a change from general building owner opinion of several years ago.

Several categories of building owners with good access to equity capital, reliable professional advice on retrofits and a long holding strategy for their buildings are retrofitting their buildings and installing retrofits of low and moderate capital cost compared to savings. Institutional owners of buildings, such as insurance companies and pension plans, have set energy efficiency goals for their property managers and routinely make capital investments in energy efficiency if they will pay back in less than 5 to 7 years (see table 4). Large corporations which generally occupy any buildings they own also install retrofits with moderately long expected paybacks (3 to 5 years). Nationally syndicated partnerships also have generous payback criteria.

Several other categories of building owners with access only to debt financing and tight constraints on the building's cash flow are only installing the most cost-effective retrofits in their buildings. Small business owner-occupants and owner-occupants of multifamily buildings expect to hold their buildings for a long time and would benefit from retrofit, but they are severely constrained by lack of access to capital and generally cannot tolerate losses in cash flow. Individual and small partnership investor-owners of buildings require that energy retrofits pay back in 1 to 2 years. They have poor access to equity capital and poor access to professional advice.

The prospects for retrofit of commercial and multifamily buildings differ. With the exception of flourishing markets in dynamic neighborhoods in such cities as Washington, D.C., and San Francisco, multifamily

Table 4.—Retrofit Payback Criteria, Holding Periods and Access to Financing, and Advice for Different Types of Owners

Building owner type	Typical payback criteria	Building for own use?	Expected holding period	Access to capital	Inhouse professional advice
Owner-occupants					
Large corporations	3-5 years	Yes	Long	Good	Good
Small businesses	1 year	Yes	Long	Poor	Poor
Multifamily owner-occupants	1-3 years	Yes	Long	Poor	Poor
Condominium	No data	Yes	Long	Mixed	Fair
Investor-owners					
Institutional owners	5-7 years	No	Long	Good	Good
Development companies	1-3 years	No	Short	Fair	Good
Partnership syndicates	3 years	No	Short	Fair	Good
Local partnerships	1-2 years	No	Short	Poor	Fair
Individuals	1 year	No	Mixed	Poor	Poor

NOTE: Long holding period = more than 10 years. Short holding period = 8 to 10 years.

SOURCE: Office of Technology Assessment.

buildings have suffered as a group from lagging rents and therefore lagging resale value (except as condominiums) that reduces their likelihood of retrofit below that of commercial buildings owned by the same owner. Where technically possible, owners of multifamily buildings have converted them to tenant utility meters so that owners will no longer be responsible for paying the utility costs. Owners of tenant-metered buildings have little or no current incentive to retrofit their buildings. Most believe that it will be a long time before owners of energy efficient multifamily buildings can charge higher rents than owners of similar but inefficient buildings.

The most likely buildings to be retrofit are office buildings, hotels, and department stores owned by a large corporation or institutional owner. The least likely to be retrofit are tenant-metered multifamily buildings owned by individuals or local partnerships.

Why Do Some Owners Forego the Large Potential Returns on Retrofit?

Most individual owners and many partnership owners will not invest in energy retrofits even if they payback in as short a period as 2 or 3 years. This unwillingness occurs despite the fact that a retrofit package with a 3-year payback will generate a very large return on investment—more than 30 percent real return per year—over a 10-year life of a retrofit installation.

High Cost of Finance

Much of real estate, including major [illegible] financed by debt, not equity. In the terms of the [illegible] leveraged. A major portion of the financing for purchase [illegible] existing building almost always comes from a mortgage

ing for expansion, rehabilitation, repair, or retrofit of a building has traditionally come from refinancing a building with a new bigger mortgage at a similar rate of interest as the original mortgage. The recent increase in interest rates has effectively eliminated that option for most building owners. No one is likely to refinance a 7-, 9-, or 11-percent mortgage at 14- to 17-percent interest in order to get funds for rehabilitation or retrofit. The primary source of funds other than mortgages for building owners is a commercial loan. These are generally 18- or 24-month high-interest loans used for financing construction projects. During much of 1980 such loans were only available at variable interest rates 2 percentage points *above* the prime rate.

A building owner, unable to tolerate much reduction in the cash flow from a building, cannot manage anything but a retrofit with a very fast payback if his only financing option is a short-term high-interest loan. Figure 1 illustrates this clearly. A 2-year payback retrofit will generate more energy savings than it will cost in debt service, even at 22-percent interest, if it is financed with a 3-year loan or longer. A 5-year payback retrofit, on the other hand, will cost more the first year in debt service than it will generate in energy savings unless it is financed for at least 10 years at interest rates of 10 or 13 percent, or for 20 years at an interest rate of 16 percent.*

Impact of Risk

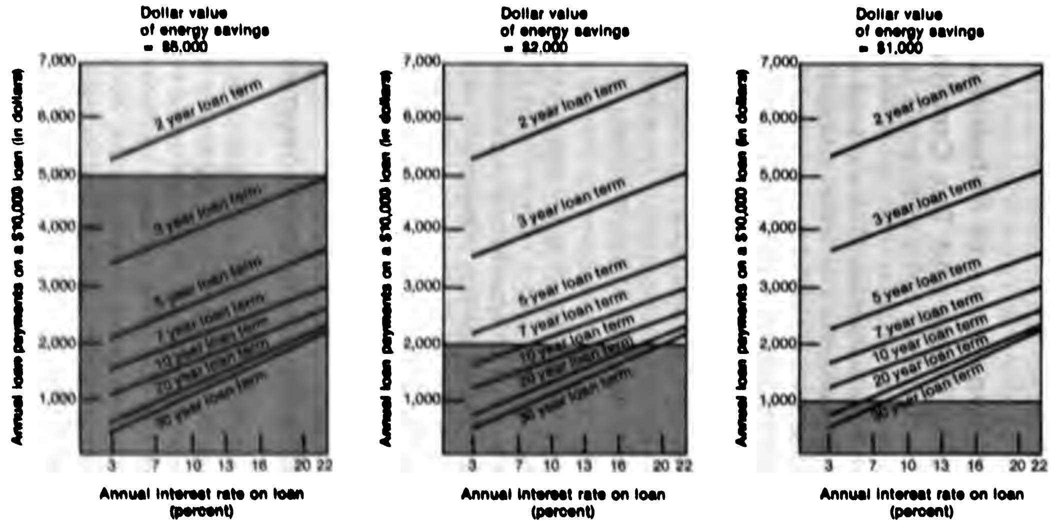
The problems faced by a building owner forced to finance a retrofit with short-term, high-cost debt are made much more serious by the uncertainty of the return on retrofit for his particular building, even though, on the average, the general prospects for retrofit are good. Based on the limited information cited earlier on the accuracy of audits, it is possible that savings from a retrofit could be 50 and even 70 percent *below* those predicted by an audit. (There is an equal likelihood that actual savings will be *above* predicted.) A predicted 3-year payback retrofit will turn into a 6-year payback retrofit if actual savings are 50 percent below the prediction, and it will turn into a 10-year payback retrofit if savings are 70 percent below what is predicted.

Extent of savings	*First-year savings from a $10,000 loan*	*Payback (in years)*
Predicted by an audit	$3,300	3
50 percent below prediction	$1,650	6
70 percent below prediction	990	10

It would be devastating, especially to many small business owners, or investor-owners of multifamily buildings, to carry the debt service for a major retrofit and fail to achieve the energy savings necessary to keep

*In years after the first year, inflation in energy costs (even if no faster than general inflation) will increase the value of energy savings relative to debt service. If energy costs increase at the rate of inflation, they will increase in current dollars and will be constant in real 1972 dollars, while fixed annual debt service payments are constant in current dollars and decrease in real 1972 dollars over time. Thus, any debt service payment in excess of fuel savings will diminish over time.

Figure 1.—Combinations of Loan Terms and Interest Rates Which Allow the Value of Energy Savings to Exceed the Cost of Borrowed Money the First Year



Case 1: Energy savings from a *2 year payback retrofit* (maximum payback considered by an individual or local partnership owner)

Case 2: Energy savings from a *5 year payback retrofit* (criteria used by corporations, insurance company owners)

Case 3: Energy savings from a *10 year payback retrofit* (maximum payback criteria of any owner interviewed)

Key:

☐ Cash flow *loss* the first year

■ Cash flow *increase* the first year

SOURCE: Office of Technology Assessment.

their cash flow up. Yet this is a realistic possibility given both the newness of the retrofit business and the individual nature of building energy performance.

The Impact of Two Forms of Subsidies: Lower Financing Costs and Tax Credits

Until interest rates drop, various subsidies from public sources or private sources such as utilities may be helpful. OTA analyzed some hypothetical multifamily buildings to determine whether a tax credit* or a financing subsidy might increase the ease of doing a retrofit and concluded from this analysis that a financing subsidy is more helpful in making retrofits possible and less expensive than a tax credit. The beneficial impact of a financing subsidy is greatest for a hypothetical low-rent high energy cost building typical of the low-rent end of the multifamily market. An unsubsidized retrofit loan (16-percent interest for 5 years) for a 6-year payback retrofit virtually wipes out the cash flow of this building.

A subsidy of approximately 15 percent to lower the interest rate and extend the loan term (13-percent interest for 10 years) restores the cash flow of the building immediately and increases it noticeably by the fifth year following the retrofit. (This analysis of hypothetical multifamily buildings is described in ch. 4.) Of the building owners interviewed, two-thirds preferred a financing subsidy to a tax credit. The one-third that preferred a tax credit included some partnerships that welcomed increased tax shelters, and also included some corporations that had adequate internal sources of finance but would benefit from a tax shelter.

When the Building Owner is the Government

Energy use in buildings owned by local, State, or Federal government is significant. About 0.5 Quad of energy was used by public buildings in 1980 and about 1.5 Quads in educational buildings, most of which are publicly owned. Much like the corporate or large institutional owner, governments and school districts have annual formal budgeting procedures which identify the importance of energy cost increases and compare them from year to year. Governments and school districts have professional general property management department and often at least part-time energy advisors.

Unlike the corporate or large institutional owner, on the other hand, government owners of buildings have severe constraints on access to capital due to constraints on annual budgets and many kinds of limits on bonding authority. The result (see ch. 9) is that government owners of buildings often implement effective *operating* programs of improved

*It should be remembered that a tax credit for energy retrofit is only one of several tax provisions that affect energy use and energy retrofit. Energy expenses are fully deductible as a business expense, while investments in energy retrofit can be partly deductible through deductions of interest rates and depreciation

maintenance and energy conservation practices by building occupants but restrict their *capital investment* in buildings to retrofits with 1 to 2 years payback. Only if the retrofit can be linked to other major repairs (such as roof insulation with new roofs) or if paid for by a Federal grant, are longer payback periods allowed.

General Prospects for Retrofit of Buildings in Cities

Public programs and private campaigns to market increased energy retrofits of buildings must take into account the variety of motivations of building owners. Owners not likely to retrofit their buildings either lack financial reason to do so, lack feasible means to do so, or both. The implications for public policy and private marketing are different for each category.

The category of owners *willing and able to retrofit* (labeled category A in table 5) do not need any additional public incentives to retrofit. Many are prime targets for private marketing efforts by companies that specify

Table 5.—Owners Likely and Not Likely to Retrofit Their Buildings

Owners' access to finance and tolerance of risk	Importance of reducing energy costs to owner's goals: Important	Importance of reducing energy costs to owner's goals: Not important
Owner can both finance and absorb risk	***A. Willing and able to retrofit*** • Corporate owner-occupants of commercial buildings • Institutional vestor-owners of commercial and multifamily buildings	***B. Able but unwilling*** • Large partnership owners of tenant-metered multifamily buildings • Well-financed owners of office buildings and retail buildings in tight, energy-insensitive markets (large partnerships and development companies)
Owner can't risk and/or lacks financing	***C. Willing but not able*** • Owner-occupants of small multifamily buildings multifamily buildings • Small business owner-occupants • Individual and small partnership owners of master-metered multifamily buildings • Individual and small partnership owners of office buildings in energy-sensitive markets • Government owners of buildings	***D. Unwilling and unable*** • Individual and small partnership owners of tenant-metered multifamily buildings • Individual and small partnership owners of office or retail buildings with net or passthrough leases in energy insensitive markets • Owners of buildings in marginal areas

SOURCE: Office of Technology Assessment.

and/or install retrofit products. Category B is *able but unwilling to retrofit.* This category of owners would be expected to respond to increased requirement for energy efficiency in existing buildings. If required, they would have the means to carry out the retrofit.

Those owners that are *willing* and even anxious to retrofit *but lack access to low-cost finance and good technical advice and cannot tolerate risk* are labeled category C in table 5. These owners would be prime targets for marketing by successful private companies organized to put up capital and absorb the risk of retrofit. These owners are also likely to respond to public programs that reduce financing costs and lower the risk of retrofit.

The most difficult to motivate are the owners in category D for they are *both unwilling and unable to retrofit.* If local governments choose to require them to invest in the energy efficiency of their buildings (through an energy efficiency code for existing multifamily buildings, for example) local government must also see to it that financing of at least moderately long terms is available, or these owners will not be able to comply with the requirement. Owners of buildings in marginal areas are unwilling to invest in their buildings unless they believe the neighborhood is viable enough to recoup their investment in the resale value of the building. For such owners, an energy retrofit program is best folded into a general neighborhood rehabilitation program which combines concentrated private investment in one neighborhood with such public investment as improved sidewalks, storm sewers, and tree planting.

There are insufficient data on either the physical nature of the building stock or patterns of ownership to allow anything but very rough estimates of the amount of energy that might be saved by each of these categories of owners. OTA estimates that about 1 Quad of the 4-Quad gap in foregone energy efficiency retrofits is attributable to multifamily and commercial building owners that are willing but unable to retrofit because they lack financing and/or access to reliable information. Another 1.5 Quads of the foregone retrofits would be due to building owners that were unwilling to retrofit their buildings because they could see insufficient advantage in doing so. About two-thirds of these owners also lack access to financing or professional advice.

The rest of the estimated 4 Quads of foregone retrofits would result from moderate and upper income homeowners in cities unable or unwilling to finance retrofits of moderate and high capital cost compared to savings (about 1 Quad) and low-income homeowners (regardless of location) unable to finance any retrofits (about 0.5 Quad).

PROSPECTS FOR DISTRICT HEATING

District heating is a system for piping heat in the form of hot water (or steam) from a central source of heat to individual buildings. Under the right conditions a well-managed district heating system may be an energy efficient way of supplying heat to city buildings.

From a national energy perspective, district heating offers an opportunity to save fuel oil or natural gas by making use of the waste heat from electricity generation for space and water heating. Hot water district heating has been widely and successfully introduced in Northern Europe over the past three decades. District heat also offers an opportunity to shift from premium fuels such as natural gas and distillates to coal or renewable resources (including municipal solid waste) for supplying heat to buildings. To building owners who are district heating customers, it promises slower increases in energy prices. For local governments, district heating can be a tool in the overall task of economic development since it uses local workers for construction and operation, helps attract new development to central city locations, and helps to stabilize energy prices for existing buildings.

For all the possible advantages of district heating, however, the design, approval, construction, and successful operation of a district heating system is a formidable undertaking whose complexity and difficulty should not be underestimated. To be successful, a district heating system must offer heat at prices that are low enough to persuade owners of existing buildings to abandon their buildings' natural gas or fuel oil boilers or furnaces, retrofit their buildings to accept the hot water (or steam) from the district heating system and continue to purchase the district heat through the life of the system. Or the system must persuade owners of new buildings of the long-term advantages of foregoing the cost of their own heating system and equipping their buildings to take district heat rather than burn fuel directly.

If general interest rates lower substantially or a substantial financing subsidy is made available, hot water district heating could become a sensible long-term investment that stabilizes fuel prices costs over the long run in one or two dozen U.S. cities. **At current high interest rates and without special subsidies, large-scale district heating may be feasible for those few U.S. cities with dense areas of customers using expensive fuel oil, and a long enough heating season to make possible a reasonably high use of district heating capacity.** This number is less than five and may even be zero. However, small district heating systems for a small number of large buildings located close together may be feasible even at current high interest rates.

PROSPECTS FOR PRIVATE SECTOR MARKETING OF ENERGY RETROFITS

In theory, there should be ample opportunity for private businesses to fill the gap between the large potential return on investment in energy efficiency and the slow pace of retrofit among some types of buildings. Businesses willing to provide the capital over a long term and willing to absorb all or part of the risks of retrofits to individual buildings ought to be able to realize part of that return.

Investors could lease energy efficient equipment to building owners and claim the tax benefits for themselves. They could install energy efficiency measures and provide energy savings guarantees to building owners. Or they could take over responsibility for the energy costs of a building as energy management companies. In the latter case the investors, in return for a monthly energy management fee, would install energy efficient equipment and assume all responsibility for paying utilities.

In practice OTA was able to identify only a handful of enterprises providing retrofit capital or absorbing the risk of retrofit. In part this is the result of the general difficulties encountered by all new businesses in a time of high interest rates. Energy retrofit enterprises, however, also face several special problems. It is difficult to predict accurately energy savings from specific energy efficiency investments partly because much retrofit technology has not yet been installed in many buildings. It can be difficult to come to a legally viable agreement on what constitutes energy savings given variations in energy use caused by changes in weather, occupancy of a building, and occupant behavior. It can be difficult to agree on a definition of the equipment to secure the investment since much energy efficient equipment becomes part of the building it is installed in.

OTA was also able to identify only a few co-ops and nonprofit corporations involved in the retrofit of buildings. Co-ops and nonprofit corporations are hampered by lack of capital and the difficulties of managing a large-scale retrofit program.

WILL GAS AND ELECTRIC UTILITIES STIMULATE INVESTMENT IN ENERGY RETROFITS?

Rapid deterioration in the financial health and future prospects for many electric and gas utilities have created more than token interest in developing energy retrofit programs. Customers are increasingly vocal against utility rate increases at rate hearings. In response to increased prices, customer demand for electricity and gas has grown more slowly than forecast a decade ago and in some utility areas has actually declined. In an era of growth in interest costs and inflation in construction and fuel costs, lags in utility ratemaking have led to utilities earning less than the designated rate of return. In response to many of these problems, some utilities have developed energy efficiency improvement programs either to improve relations with customers, earn a greater return, or both.

Some utilities have energy retrofit programs in response to directives by their State regulatory commissions (e.g., Florida, New York, and California) and others developed energy audit programs on their own. In all, about 65 utilities offered residential energy audits as of the winter of 1977-78 *before* the Federal Residential Conservation Service (RCS) program was announced. Even if such audit programs are no longer man-

dated by the Federal Government under the RCS, many utilities are likely to continue them. Customer demand for utility audits, however, is likely to remain limited unless the utility markets audits vigorously with an eye to achieving measurable energy conservation goals.

A few electric utilities have built energy retrofit programs into their projections for future generating capacity and have deliberately exchanged planned new capacity for planned curtailment of demand. The New England Electric System (NEES) for example has announced a program to assist in the retrofit of commercial buildings for load management, thus reducing the need for new peak generating capacity. As now structured, the NEES program would not affect residential buildings much at all.

Theoretically, both slow-growing utilities, like NEES, which have time to plan and assess conservation, and fast-growing utilities, such as those in Florida who have to try everything to avoid falling short of meeting demand, could build energy retrofit programs into their strategic planning. In practice, utilities who do this must have the innovative leadership to develop new products, new marketing techniques, new customer relations, and new forecasting and monitoring techniques. **In a period when utilities are struggling against very difficult financial problems, OTA concluded that few may develop the leadership to undertake ambitious large-scale energy retrofit programs on their own**. A larger number of utilities may be willing to cooperate with State governments that are promoting energy retrofit programs as in Florida and California. As electric utilities become increasingly interconnected across State boundaries, there could be a role for the Federal Government in encouraging cooperation among State utility regulatory commissions as they integrate conservation goals and planned new electric generating capacity. Utilities, however, will continue to look to the State ratemaking process for encouragement or discouragement of conservation programs since State level ratemaking determines utility return.

PUBLIC SECTOR PROGRAMS TO STIMULATE ENERGY RETROFITS

Potential Role of City Governments in Urban Building Retrofit

A few visionary leaders in a few cities have created a link between the energy retrofit of local buildings and such broad goals as the long-term viability of the housing stock, and the long-term stability of regional income and economic productivity. They have promoted this view in speeches and reports and encouraged citizens to be aware of energy and its role in the city or region.

In most cities, however, citizens' worry about rising energy costs has been more directed at the local utilities, and mayors and city councils feel little pressure in city hall to do anything directly about energy. Most

cities do not have active energy programs. Only 5 percent have full-time energy coordinators; most of the part-time energy coordinators spend less than 1 day a week on energy. The primary energy concern of most mayors and formally designated city energy coordinators is to reduce the growing share of energy cost in the cities budgets.

For some cities energy problems do "reach city hall" in the form of complaints about landlords' failure to provide adequate heat. In New York City, for example, the number of such complaints increased from 225,000 in 1978-79 to 320,000 in 1980-81. In cities where a metropolitan oversupply of housing softens the market for rental housing in the center city, the rapid increase in energy costs is sometimes perceived as a trigger for landlord abandonment of buildings. Such abandonment has been reported as severe in such smaller cities as Rochester, N.Y., and Springfield, Mass.

Many cities have incorporated energy retrofit into their housing rehabilitation programs. These are usually financed by Federal community development block grants (CDBG) or other housing rehabilitation funds. Linking retrofit to general housing rehabilitation has two advantages. It makes possible general repairs in roof or windows that are needed to make the energy efficiency measures work. It also addresses the concern of property owners confronting a retrofit investment that the building as a whole have resale value and that the neighborhood it is located in be economically stable. Housing rehabilitation programs in cities generally proceed neighborhood by neighborhood, often combining support for private rehabilitation with expenditures on such public works as sidewalks. **A program that promotes energy retrofit in the context of general property upgrading fits well with city government concern for the general health of the housing stock and the property tax base.**

Cities have other ways to promote building retrofit besides their housing rehabilitation programs. They may promulgate energy efficiency building standards at time of sale (Portland), issue municipal bonds to subsidize private retrofit expenditures (Minneapolis and Baltimore), or manage Federal weatherization directly and vigorously (Des Moines) rather than allow it to be administered by local nonprofit antipoverty agencies.

Potential Role of State Governments in Urban Building Retrofit

Some States have active energy audit or retrofit programs with potentially far-reaching results. Florida and California typify one source of motivation for States. Both States have rapidly growing populations and projected requirements for continued expansion of electrical generating capacity. Both States have difficulty finding large number of sites for new powerplants. Although their climates are mild and yearly energy bills lower than States with colder climates, both States face certain increases in natural gas prices and possible sharp increases in electricity prices if

powerplant capacity must be added very fast. Florida and California have both required that utilities develop extensive energy audit programs. linked to slowdowns in construction of new generating capacity.

New York, Minnesota, and Massachusetts on the other hand have slowly growing or stable populations. State officials are not concerned about utility construction plans since utilities in these States are likely to face economic problems caused by excess generating capacity rather than the need to construct new generating capacity. Rather, State officials are motivated by concern about the health of the housing stock and hardship caused by the combination of high energy prices and severe winters.

States seeking to bring about large-scale retrofit have several possible tools to use. They may require high-powered utility audit programs (generally using the framework of the Federal RCS audit program), bring effective management to bear on the Federal weatherization program (Pennsylvania), require energy efficiency building code standards for new or existing buildings (Minnesota), or occasionally provide their own subsidized financing for energy retrofit (New Jersey).

For every State, however, which has developed programs to stimulate building retrofit, there are many States with similar concerns which have not developed active retrofit programs. Like cities, States have many other demands on their economic and managerial resources. Thus, State stimulus of building retrofit is likely to remain uneven, strong in some States and weak or nonexistent in others.

THE FUTURE: FEDERAL POLICY OPTIONS FOR STIMULATING THE RETROFIT OF BUILDINGS IN CITIES

Many programs developed or implemented by States and local government actually originated with the Federal Government. After 7 years of steadily increasing Federal involvement in energy conservation since the 1973 oil embargo, a basic shift in emphasis is now underway. All but a few of the Federal energy conservation programs have been substantially reduced in the 1982 budget.

The current debates about the proper role of the Federal Government in energy conservation, housing and community development programs, and assistance to the poor will affect the nature of the Federal role in stimulating the retrofit of buildings in cities. The following discussion of the Federal roles advocated by different parties to the debate.

Option A: No Direct Intervention

The rationale for this option for the Federal role is that energy retrofit is best left to the private sector. If managerial and legal problems can be solved, a wide variety of innovative, technical, and financial approaches will be developed by the private sector over the next decade to ta'

vantage of the investment opportunities presented by retrofit. Efforts to reduce the high risk of retrofit by more accurate documentation of energy savings will eventually be better undertaken by trade associations and other private organizations with a stake in the results than they would be by the Federal or other levels of government.

Under this option, State governments and city governments would be free to develop energy retrofit programs of their own: States, as part of their regulation of public utilities; cities, as part of community development programs. Federal efforts to stabilize the economy, to allow accurate energy price signals and to lower interest rates are viewed as the only legitimate Federal role in accelerating retrofit opportunities.

Option B: Small Federal Market Assistance Role

Under this view, the private market must be assisted by the Federal Government because there is a strong national interest in higher energy efficiency, and because it is possible that the private market, by itself, is insufficient to satisfy national need and to maximize economic efficiency. On the other hand, according to this view, constraints on the Federal budget are severe enough to prohibit all but a small Federal role.

Even with a fairly low budget, however, the Federal Government could develop a clearly focused, research, development, and information program to reduce the risks of retrofit. Such a program is probably best modeled on private sector efforts in order to ensure maximum information exchange. Several restaurant chains have set up proprietary programs to test retrofits in different building types. Sears & Roebuck explicitly tested several kinds of retrofits in its stores before launching a multimillion dollar retrofit program. An ongoing Department of Energy program to test retrofits to hotels and motels and disseminate the results through the American Hotel & Motel Association could be expanded to other trade associations and other building types. The most urgent need is to document retrofits within the multifamily building sector and publicize them through the several multifamily trade associations.

Small-scale Federal retrofit subsidy programs, such as the schools and hospitals program and the Solar and Conservation Bank (described in ch. 9) would have the most impact if used primarily to increase knowledge and reduce the risk of retrofit. Public housing modernization funds used for energy retrofit of public housing could be used to document energy savings from energy retrofits. Under this approach, private building owners or public housing authorities receiving subsidies, would be asked to participate in a program to describe and document the results of the retrofit and disseminate it, through trade associations and chambers of commerce, to other building owners.

Option C: Large Active Federal Role

This Federal role would be consistent with both an activist philosophy of government and the view that reducing U.S. energy use over the long

fit is an important national goal for reasons of national security, minimizing disruption to the environment and maximum economic growth and competitiveness. Under the rationale for a high budget Federal role, if energy retrofit is the path of least total cost and if it is not likely to come about because of the nature of the energy problem and private markets, then the Federal Government should encourage and subsidize energy retrofit to the point where the major part of the cost-effective retrofit actually occurs.

This Federal approach should first and foremost include the risk-reducing activities described in the low budget approach above. A reduction in the perceived risk of a retrofit is essential if all building owners are to take advantage of a financing subsidy and make the investment. Vigorous promotion of State and utility development of audit programs for all building types and development of audit training programs would also, under this approach, help reduce the perceived risk of retrofit.

The Federal Government already provides a major financing subsidy to single-family homeowners in the form of a residential energy tax credit. About 4.8 million taxpayers used the credit in 1979 to make about $5.5 billion worth of energy efficiency investments. The credit cost the Treasury about $440 million. Multifamily building owners currently have no effective access to energy tax credits (although there is a narrowly defined business energy tax credit for improving the energy efficiency of industrial processes).

A new Federal effort to subsidize energy retrofit could either extend the energy tax credit to multifamily and commercial building owners or it could take the form of a program to subsidize interest rates and extend energy retrofit loan terms to such owners. OTA estimated the approximate size of a large-scale effort designed to produce 2 Quads of annual savings through retrofit at the end of 10 years. A subsidy used to lower annual interest rates by 2 to 3 percentage points and extend loan terms could subsidize about $4 billion worth of retrofits per year at an annual cost of about $600 million, a little more than the current cost to the Treasury of the residential energy tax credit (see table 6). The assumptions behind this estimate are described in ch. 11.

Table 6.—Two Forms of Federal Subsidy

Subsidy type	Cost per year	Energy impact	Estimated value of savings (in dollars)
Subsidized $40 billion in conventional loans over 10 years for energy retrofit	$600 million	2 Quads saved annually after 10 years	$14 billion to $30 billion per year
Ten district heating systems allowed to use tax-exempt financing ($1.5 billion each) constructed 10 years	$600 million	0.3 Quad displaced annually from fuel oil or gas to coal, solid waste or waste heat after 10 years	$1.2 billion per year

SOURCE: Office of Technology Assessment.

An active Federal approach might also include a financing subsidy for district heating, most conveniently by permitting tax-exempt bonds in magnitudes greater than the currently allowed $10 million. A subsidy to permit 10 systems of $1.5 billion each in 10 cities is likely to cost annually about 4 to 5 percent of the system (in foregone taxes on tax-free bonds). The 10 systems could be expected to displace about one-third of a Quad of fuel oil or natural gas and substitute coal, heat from solid waste, or waste heat from electricity generation.

Two Quads of energy savings per year is a substantial amount of energy. It is the equivalent of 1 million barrels of oil per day, or about 20 percent of all U.S. oil imports in 1981. It is also equivalent to about 36 electric generating plants of 1,00 MW each, at average utilization rates. There are two ways of estimating the value of 2 Quads of energy savings in 1981 dollars; they would be worth $14 billion at the 1981 average price for home heating oil of about $1 per gallon, or $20 billion to $30 billion at the current estimated price of synthetic oil from coal in 1981 dollars. (See the forthcoming OTA report on synfuels for further discussion).

The value of savings from an equivalent subsidy to district heating is much less. If district heating primarily serves to shift demand from premium fuels, such as oil and gas to coal, the savings comes from the price difference between the two kinds of fuel. At $4 per million Btu (about the current price differential between oil and coal for utilities), substituting 0.3 Quad of heat from coal for heat from oil would be worth $1.2 billion.

It also may be possible, although OTA has not analyzed this option, to achieve the same impact on energy retrofit not by subsidizing retrofit but by reducing or eliminating the tax deduction of energy costs as a business expense, since this tax deduction has the effect of subsidizing the inefficient use of fuel.

NOTE: Copies of the full report "Energy Efficiency of Buildings in Cities" can be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

General Information

Information on the operation of OTA, the nature and status of ongoing assessments, or a list of available publications may be obtained by writing or calling:

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Publications Available

OTA Annual Report.—Details OTA's activities and summarizes reports published during the preceding year.

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Chairman GONZALEZ. Thank you, Dr. Gibbons, very much, and this was a very, very good testimony.

Certainly let me say that by the time we get into markup on this, H.R. 5731, this will be one of the items and some of your recommendations are going to be evaluated.

The one thing that comes to mind was the trip that the subcommittee made to California in January. Did your study delve into the California area?

Ms. PROCTER. We did describe some of the California programs, the many different California programs for stimulating energy retrofit, some of the most powerful of which are coming about through the utilities.

Chairman GONZALEZ. I recall vividly a fairly new public housing project that had some solar energy facilities.

But when I asked, they said, well, we are sorry, but we haven't been able to use them. They haven't really worked out.

On the other hand, I visited another one they were fairly pleased, even though the use was limited, I believe, to the heating of water.

I talked to the director, and he wasn't able to explain to me, either in general or in technical terms, why it was that they had installed the facility and it had not turned out to be workable. Well, he really didn't know. And I was just wondering if your office had had any requests for such assessments because it seems to me such a tragedy that they had the foresight and willingness to go into energy conservation, switching from the more expensive energy sources into what was natural in that area, which was solar—but it didn't work.

Dr. GIBBONS. Mr. Chairman, what you have well illustrated is one of the opportunities that the Federal Government has to assist those people in cities and working in State and local government providing habitat, to give good advice on what does make sense and how to do it, so that we share all the way across this country the information on how to do it.

There is no question but what we know how to make energy efficiency, very, very effective in housing, whether it be new or retrofitted housing, but that flow of information ultimately to the person doing the work is a very constrained flow and needs help.

I believe that is a traditional role of the Federal Government. There is a lot of leadership going on in California and energy consciousness there that exceeds some of the other States.

I know the city of Davis has had a lot of work in that regard. The people at Lawrence Berkeley Laboratory at Berkeley have done a substantial amount of work in both design as well as in monitoring of these successes, as have also people at the Oak Ridge National Laboratory.

Where we have found successes is where good advice is available. For example, the Tennessee Valley Authority, within their five-State region, have provided good advice to homeowners and to larger building owners so that the owners have a sense of what can be done.

Then the Tennessee Valley Authority has provided lists of qualified contractors and if the home or building owner decides to have the work done, he arranges for it to be done and then the Tennes-

see Valley Authority sends in an inspector to make sure the job was done as prescribed and then undertakes the loan on which the thing is paid back.

This business of giving good technical advice at the start and then a qualified certification by post-installation inspection has resulted in a very high performance of this.

If I might, I would like to ask Ms. Procter if she has anything more directly to say about your concerns.

Ms. PROCTER. In one of the other case study cities that we analyzed, we ran into a situation in which a public housing authority had installed several solar devices—some of which were working and some of which were not.

That same housing authority had not done a comprehensive energy analysis. We do feel that solar devices should be part—or the opportunity for solar devices should be considered as part of an overall conservation plan, and in some cases, they make good sense in the right climate.

In other cases, they are either more expensive or more risky than similar conservation investments that have the same effect, that also reduce energy going to hot water.

And we were disappointed in this particular case that this solar device had not been installed as part of a comprehensive audit.

It turned out that it was installed because there was Department of Energy money available which helped cut the cost, and this was not our view of what was a sensible way for the Federal Government to influence at least an overall plan for public housing energy efficiency.

It might have been fine to demonstrate a solar device, but not a sensible way to approach a more general problem.

Chairman GONZALEZ. I asked the director of the California State agency if they had had any contact with the Office of Technology Assessment, and I hate to tell you this, but they acted puzzled. They weren't aware of the office.

So then my next question was, if the State housing agency had any programs. The representative said that he felt that the State of California State agency did have a program for technical assistance, but he wasn't quite clear.

And specifically in that regard, he really didn't know. So my question next is this. Do you have any knowledge or any opinion as to the extent to which HUD, the Department of Housing and Urban Development, has provided funds or technical assistance to the public housing authorities with respect to energy efficiency and such things as the sufficiency of these energy conservation improvements?

What is your impression, or do you have any opportunity to evaluate the Department's activity in this respect?

Dr. GIBBONS. Mr. Chairman, it is interesting, the State of California's offices in Washington are two floors below my office and Governor Brown spent a very interesting hour or two with us a few months back talking about the office.

We are obviously a small agency covering all of technology and we work for the Congress, so we can't handle a lot of traffic from the States, but we are hopeful that our reports will be used by the States to the fullest extent they can, and we intend to let all t

governors know of the existence of this work and hopefully they will find it useful.

I think in terms of the degree of expertise and the extent of assistance given by HUD to the local housing agencies, it is a matter of some concern.

I think probably Ms. Procter can speak more directly to this than I. I did mention one report done for HUD that we understand has not been distributed.

Chairman GONZALEZ. No, we have not had any kind of a report from HUD. But we are accustomed to that now after 13 months.

Ms. PROCTER. I will confine what I say to what we learned based on our case study analyses. It is very difficult, as you know, to get comprehensive information on HUD activities, particularly when they are carried out through the 90 area offices, so I will not vouch that what I say applies to all HUD offices.

In the five case study cities that we visited, there was no particular provision of technical assistance by the HUD area offices to the public housing authorities.

There is some technical assistance provided in the form of courses and opportunities for workshops to the housing rehabilitation programs. That is part of the housing rehabilitation program in HUD.

And that has not yet, as far as I can tell, been expanded to include a great deal of information on multifamily buildings.

By and large, that technical assistance and availability of workshops is more directed at single-family housing, which are the targets of the rehabilitation programs.

We may yet be informed that there is a lot more going on than we were able to find out in the short time we had to cover all government programs, but it is our impression that HUD could strengthen the analysis of retrofits, specifically to multi-family, and that would be useful both for public housing authorities and for privately owned multi-family buildings being assisted by HUD programs.

They made a good start in commissioning the assessment of the physical condition of public housing. It is our belief that that report has not been widely distributed even though one volume of that report is in the form of an excellent energy conservation handbook, which is as good as any I have seen in describing the measures that can be taken and describing them in ways that are very understandable to someone who is not himself an energy expert.

So that HUD already has at hand the wherewithal to improve its technical assistance.

Chairman GONZALEZ. I wonder if you could, for the record, designate the five areas of study. I believe you mentioned five.

Ms. PROCTER. Yes. They were Buffalo, N.Y.; Jersey City, N.J.; Des Moines, Iowa; Tampa, Fla.; and San Antonio, Tex.

Chairman GONZALEZ. I wonder, Dr. Gibbons, if you could elaborate on the usefulness of better data on the results of the energy retrofit?

Dr. GIBBONS. Yes, sir. I mentioned that uncertainty in the actual outcome of a retrofit constituted an important uncertainty in terms of the willingness of an investor to make an investment.

I mentioned that sometimes the retrofits turn out to be twice as good as predicted, but also sometimes they turn out to be only half as good as predicted.

That is not because of a faulty technology. It is because of the problem of transferring what you know how to do in a laboratory to the actual field conditions of an actual building.

So if there is any way one can reduce the amount of uncertainty that the investor faces in understanding how much energy he is going to save, then he is going to make a stronger investment. Technical work to evaluate the performance of actual retrofit so that the experience is well understood should reduce this plus or minus 50 percent down to plus or minus 20 percent or less. We know it can be done. This will allow the investors to make larger investments because their risk is less in terms of being able to make their payments.

Chairman GONZALEZ. You mentioned the opportunity for third-party investors. Could you elaborate on that, sir?

Dr. GIBBONS. I will ask Ms. Procter.

Ms. PROCTER. This is an opportunity for third parties, people who are neither the retrofitter or the owner of the building, to pay for energy retrofits—put up the capital and take advantage of the tax credits for equipment and in some cases, energy tax credits for energy investments, and thus these people can reap the benefits of the tax credits against their own substantial income.

This opportunity has been described to us and we have been trying to find out how many such deals are actually being made, and it appears that the motion is accelerating and that, in fact, the legal problems of working out such deals are being overcome.

It is complicated because the equipment becomes part of the building that it is invested in and defining the security for the investor is difficult, and there are also great difficulties in defining the energy savings themselves, and how much the building owner takes credit for and how much the investor should take credit for.

But some progress is being made and it may turn out that over the next few years, this will become a more prominent way of bringing capital into these buildings where the owners themselves do not have much access to capital.

It certainly bears watching.

Chairman GONZALEZ. This was one big thing I was sold on with respect to the solar bank, but, of course, that has been done in, and I was just wondering if a reactivation of that, even minimal, in your opinion, would be helpful?

Ms. PROCTER. One particular group of buildings to which the solar bank could be targeted specifically is multifamily buildings. Instead of trying to cover a great many different kinds of buildings and different kinds of investments, it might be used specifically to provide finance subsidies, and particularly, the stimulus of longer-term loans for multi-family buildings, and that might have an impact.

Chairman GONZALEZ. Certainly, because you know this has been the litany. Almost every witness we have had at some point in his testimony has said, under the equivalent circumstances, what you have said, deprived of access to credit, long-term, affordable, this and this can't happen.

We heard that all last week, all this week, I don't care who it was, somewhere in the testimony. I have been struck with that.

But I think the most lamentable thing I have heard was yesterday in the same words. We had the commissioner of banks, I believe from New York, coming in, and she was presenting us the first book of this savings bank that had just been lost and then she gave us the reasons, so that that is the fundamental problem.

But it just seemed to me that in the case of a solar bank, that we should have had some little respite from the administration until we could refine it and very much along the lines that you are recommending, which is, I think, very true.

Thank you very much, and let me say that if it appears to you that, there being a big absence of members, that might be frustrating or disappointing, it shouldn't be, because some of the members, once the House ended whatever formal business it had at this time, I would say that almost 100 percent of the members are on their way or are already back in their district, and that they will have copies of this testimony, the members of this subcommittee.

They will also have copies of the transcript. So some may be submitting questions to you.

Dr. GIBBONS. We would be pleased to answer them.

Chairman GONZALEZ. For reply in the transcript, assuming they will do it promptly and in time to give you a chance.

I can't tell you again how grateful we are for the work you have done, the work you are doing and the time you have taken to be with us this afternoon.

It was very important and you are absolutely correct, this was the subcommittee that directed the request and it was coincidental that we should get the copy today.

So thank you again very much, Dr. Gibbons.

Dr. GIBBONS. Ms. Procter and I are delighted to be with you today and appreciate your invitation.

Chairman GONZALEZ. We appreciate you and Ms. Procter, particularly since she has been to my district and has also made the acquaintance of one of my greatest couple of friends that I have in San Antonio.

Ms. PROCTER. San Antonio was the high point of our study.

Chairman GONZALEZ. Thank you. I was born there. Contrary to what some people think, I wasn't born in Mexico.

We next have Mr. James E. Jones, Jr., the government affairs representative of the Alliance of American Insurers; Mr. George K. Bernstein, our long-time friend, and truly a great public servant, representing the American Insurance Association; Mr. James M. Shamberger, senior vice president of the Reinsurance Association of America; Mr. Charles H. Fritzel, assistant vice president of government relations of the National Association of Independent Insurers; Mr. J. Robert Hunter, president of the National Insurance Consumer Organization; and Mr. Barry Mersky, insurance agent of the Global Insurance Co.

Gentlemen, we have a table big enough and we have a sufficient number of chairs and we have even got your nameplates all fixed up.

Gentlemen, we apologize for the lateness of the hour, paucity of [illegible]dance, and we appreciate and thank you for your patience.

Let that not diminish the importance of the subject matter on which you appear, and above all, the importance of your presence and your testimony.

Let me tell you, it is deeply appreciated.

Does any one of you have a particular time problem so that we could, with no objection, recognize you and allow you to go on?

If not, if there is no objection, shall we proceed with the representative of the American Insurance Association, Mr. Bernstein?

STATEMENT OF GEORGE K. BERNSTEIN, REPRESENTING THE AMERICAN INSURANCE ASSOCIATION

Mr. BERNSTEIN. Thank you, Mr. Chairman. I will briefly attempt to summarize my statement, if that is all right with the subcommittee, and submit the rest for the record.

Chairman GONZALEZ. It certainly is and we appreciate that because of the limitation and the number of individuals following you.

Mr. BERNSTEIN. The American Insurance Association has, since the inception of the program, supported the flood, riot and crime insurance programs. As far as the flood program is concerned, today we believe that the same principles that caused its creation in this 1968 legislation still exist; namely that flood insurance is not something that can be provided by private insurance companies, because of the nature of the risk; that premiums would be too high for people to afford.

As a result, Congress enacted a program which involves subsidy for existing structures, the tradeoff being to require land use, loss mitigation measures with respect to new construction, which would pay acturarial rates and be able to afford the rates through sound building and locational practices.

As a result of the nature of the program, the losses experienced have been significant. We do not believe that those losses should come as any surprise.

These losses don't condemn the program. In fact, they are an indication that the program was necessary and, to a great extent, is working, if the second half of the program is also enforced, the land-use measures.

On the premise that the land-use measures will continue to be enforced and that this administration will continue them, we continue to urge support for the program and extension of it.

The Administrator of the Federal Insurance Administration has indicated an interest in returning private industry to the flood insurance program.

He recognizes that it is premature to expect the industry to participate in a risk-bearing role, particularly when the losses are as heavy as they are.

He is attempting to restructure the rates in the program to make them more actuarially sound.

Many of us do not believe that we are going to see actuarially sound rates existing in our lifetime, but nevertheless, we are prepared to respond favorably to exploration of the possibilities of reentering the program on a servicing basis as that possibility makes itself available.

We understand that the contract with EDS Federal, which expires November 3, will be extended for another year by FIA, so therefore, it is academic for the forthcoming year as to what the private insurance industry role might be in terms of servicing contracts, issuing policies, handling claims, but that is something we are prepared to explore as the administrator develops the program. The bottom line is that we urge continuation of the program.

With respect to the riot reinsurance program, again, this is a program that was supported strongly by the American Insurance Association companies.

They were among the leaders in taking advantage of Federal riot insurance. The program has been a self-sufficient program from day one.

There has never been a penny of Federal subsidy involved. In fact, the Government made $120 million selling it. That $120 million surplus has been eaten up by the losses of the crime program, which were never appropriated for, and today we understand that there is borrowing into the quarter-billion-dollar borrowing authority of the National Insurance Development Fund from the Treasury and the Fund has no money in it.

As a result of depletion of the money in the Fund and in an effort to fund the riot reinsurance program, last year the administration multiplied the premium structure by 10, raising the rates from 2½ cents a $100 to 25 cents a $100.

The 25-cent rate was so clearly excessive that few companies bought it. In fact, only one of the 150 American Insurance Association companies has bought that insurance this year.

As a result, and because of a number of factors including the depletion of the Fund and the possibility that if there are riots—because there is no surplus in the Fund—the companies are open to assessment by the FIA, although AIA was the only trade association last year to urge extension of the program, the AIA has not yet finalized its position for this year.

There is a difference of opinion within the companies. Many companies feel that at the 25-cent Federal rate private insurance is so much a better buy, and many companies feel that regardless of the rate, there is currently adequate private riot reinsurance and there is no need for the Federal program.

Others feel while there may not be a need today, we don't know what tomorrow will bring, we don't know what will happen to the market, and as a result, the Board of Directors will vote on April 7th on the position to take on the riot reinsurance program and will report to this committee on the result of that vote.

With respect to the crime insurance program, the AIA again urges continuation of the program. We recognize that in most of the States where the insurance is available, there is not a heavy utilization of the program, that the number of insureds, business, and residential, has not been great over the years, but we believe in the basic premise on which the program was brought into being, namely that in high-loss States, it is impossible to make crime insurance available for high-risk insureds in high-hazard areas at rates they could afford.

That was the premise of the bill originally. In States such as New York, which has the bulk of the business, the bulk of the

losses and the bulk of the risk, there is no way that without a heavy subsidy, private insurers could make this insurance available.

We believe that for high-risk areas the Federal crime insurance program is the best solution possible and we have not, as an association, been able to develop a better solution ourselves.

We do not believe that in high crime areas we can make this insurance available at rates that people can afford, because of the nature of the private insurance mechanism, where rates are to be set on the basis of actual experience.

Therefore, the subsidy is needed. We believe the Federal program is still the best solution. Thank you very much.

[Mr. Bernstein's prepared statement on behalf of the American Insurance Association, and a letter, dated April 19, 1982, in regard to the referred-to April 7 meeting of the association's board of directors, follow:]

TESTIMONY OF GEORGE K. BERNSTEIN

On Behalf Of

THE AMERICAN INSURANCE ASSOCIATION

Before The

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
Of The
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

April 1, 1982

The American Insurance Association (AIA) was one of the leading proponents and supporters of the National Flood Insurance Program and the Urban Property Protection and Reinsurance Program, both of which were enacted in 1968. Since the passage of the Federal Crime Insurance Act in 1970, AIA has also supported the goals of that program.

After more than a decade of operation, Congress is again faced with the question of whether these three programs should be continued beyond their expiration date of September 30, 1982.

National Flood Insurance Program

The National Flood Insurance Program was enacted because broadly based, self-supporting private insurance against flood losses was impossible. Congress recognized that the flood hazard is essentially uninsurable. Floods combine the elements of low frequency of occurrence and high severity of loss that are inconsistent with a sound insurance program because of the inability to spread the risk and the resultant extreme adverse selection.

Comparatively few persons expect flood losses and only the most hazardously located of these choose to purchase insurance. Of those insured, a relatively high percentage actually suffers losses. Accordingly, with a small premium base from which to pay losses to those insured properties that are flooded, the premiums required from each insured to cover the exposure would be prohibitively expensive.

Congress appreciated these problems, and undertook the development of the National Flood Insurance Program with no illusions. The 1968 Act was a trade off. It provided that the federal government would compensate victims of flood losses

who had already located in flood prone areas. However, with respect to new construction in areas where the flood hazard was known and documented, federal flood insurance would be available only if proper locational and construction decisions were made by committees and individuals.

Congress also recognized that the cost of flood coverage would be equally prohibitive whether it was sold by the federal government or private insurers. Thus, Congress provided for heavily subsidized premium rates for existing construction and established a federal mechanism for covering the deficit.

Subsidies against the real cost of coverage were at the heart of the National Flood Insurance Program. If subsidies had not been necessary, there would have been no need for a federal program. If subsidies had not been provided, a federal program would have been a failure.

Nevertheless, the Act directed that after appropriate technical information on the flood hazard had been provided to local communities, premium rates for new construction would be set on an actuarial rather than a subsidized basis. Congress so structured the Act for several reasons: no subsidy was intended for development that disregarded actual documentation of flood hazards; actuarial rates for new construction would create an economic incentive for safer development; and if proper construction practices were implemented, properties were likely to be sufficiently safe from flooding to permit premium rates that were affordable without a subsidy.

As Federal Insurance Administrator, I testified before this Subcommittee, the Senate program Subcommittee and the

Appropriation Subcommittees of both houses over a period of five years. Each time, I advised the committees that the flood insurance program was insurance in name only. Despite the fact that we know far more about flood damage and its mitigation than about such other hazards as earthquake, even the setting of actuarial flood insurance rates is far from a science. The unpredictability of wind and wave elements, the low frequency, high severity nature of the risk and the need to use such estimates as the "100 year flood" as a standard for both ratemaking and hazard mitigation, do not permit the precision that one would hope for in an insurance program.

Accordingly, massive losses and high cost to the Treasury were expected for many years until the location and quality of new construction and the premiums allocable thereto would overtake the risk represented by structures currently exposed to severe flood damage.

Moreover, Congress appreciated that with the premium subsidy and actuarial uncertainty inherent in the program, unless the hazard mitigation requirements of the Act were strictly enforced, the massive costs would be unjustified. Absent such enforcement, relatively inexpensive federally subsidized premiums would actually encourage irresponsible construction in flood prone areas. The result would be greater losses than would have occurred without a federal flood insurance program.

It should come as no surprise that the program has paid well over a billion dollars in claims, which even without the significant additional expenses of engineering and mapping and the administration of the program, far exceed premium income.

These costs constitute an investment in the long term goal of safer construction and wiser use of flood prone areas, and reflect the underlying premise of the program that eventually the cost to taxpayers would be less under a balanced flood insurance program than under the haphazard, ad hoc approach of disaster relief.

Whether this investment is paying off is a question which Congress must assess in determining whether to continue the commitment of taxpayer dollars to the subsidization of flood insurance. Under the 1973 Flood Hazard Protection Act, which mandates that flood insurance be purchased for any structure in a high hazard area if a mortgage is issued by a federally insured lending institution, the current $100 billion of federal exposure under this program will continue to grow. Only if the program is administered efficiently and the hazard mitigation provisions are wisely and earnestly enforced will the federal investment be justified.

The Federal Insurance Administration (FIA) has reaffirmed its commitment to the hazard mitigation aspects of the program. Nevertheless, there are very real pressures from private, local, state and federal sources who would prefer that enforcement take place in someone else's community or not at all. Unless the Congress and the Administration encourage the FIA to withstand these pressures, the goals of the program will not be achieved.

The new Adminstration of FIA has indicated its desire that private insurers again play a role in the flood insurance program. Until 1978, insurance companies bore a share of the

underwriting risk of the program.* In addition, in return for servicing fees, private insurers issued policies and handled claims for the FIA. Since 1978, the federal government has taken over both risk sharing and servicing of the program, with the latter function contracted out to a non-insurer.

Inasmuch as one of the goals of the original flood insurance legislation was that the federal role would gradually diminish and be replaced by an increasing private insurance responsibility, eventually eliminating the need for any federal insuring role, the AIA welcomes the desire by the FIA to explore renewed private insurer involvement. The AIA, together with other segments of the industry, has already met with the FIA and the President's Commission on Housing to discuss this possibility. The AIA is prepared to assist the FIA and AIA companies will make their expertise available to the FIA in its efforts to restructure the program.

The Administrator of the FIA has recognized that a private risk bearing role is premature, and has stated that he does not seek such an industry commitment at this time. The AIA concurs with the Administrator, and believes that private risk bearing by insurers must await a number of developments. These include resolution of the issues raised by the GAO, the implementation by the Administrator of his 12 point operating plan, evaluation of the impact of the proposed premium rate increases, and most importantly, assurance that the hazard mitigation provisions

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* The industry share was roughly proportionate to the ratio of the premium dollars actually realized through subsidized rates to the actuarial rate. Insurers also could purchase reinsurance from the federal government against excess losses.

of the 1968 legislation are being carried out and can be expected to have the continued support of Congress and the Administration.

Whether a private risk sharing program, similar to or incorporating the principles of the industry-FIA agreement that was abrogated in 1978, can be reconstituted, thus depends on an assessment of the fiscal and political climate to determine if a viable, soundly based flood insurance program is feasible, and if the insurance industry can work out a cooperative arrangement through which its interests and those of the public are adequately protected.

It has been suggested by the FIA that even in the absence of a private risk bearing role, insurers may be interested in acting in an administrative or servicing capacity to the National Flood Insurance Program. We are advised that the servicing agreement between FIA and its current contractor, EDS Federal, expires on September 30, 1982, but that FIA intends to extend it for one year. There are, no doubt, certain AIA companies that might wish to explore what role they could play to supplement or replace EDS Federal's. Among the open questions are whether insurers could bid, individually or as a group, on the servicing of certain jurisdictions or if the contract will be rebid on a country wide basis, and whether insurers will be able to bid on all or a portion of the functions now being performed by the contractor.

In any event, the AIA will certainly offer the FIA whatever technical assistance is possible, at the same time that

the insurance industry evaluates the potential for a private risk bearing role.

Regardless of the extent to which the private insurance industry may participate in the federal flood insurance program, and even if there are substantial program changes, including establishment of higher actuarial rates, increases in the chargeable rates, larger deductibles, and other efforts to close the gap between premium income and payouts, no one should be under any illusion that the need for substantial federal subsidies will disappear.

Given the vast majority of "existing" structures that will continue to populate the program for years to come, and the Congressional mandate that such properties not be required to pay more than an "amount... consistent with the objective of making flood insurance available where necessary at reasonable rates so as to encourage prospective insureds to purchase such insurance and with the purposes of this chapter,"* premium income will be inadequate to support the program for the foreseeable future. Accordingly, the reasons why the private insurance industry was unable to provide flood insurance on a broad, self-sufficient basis, and why Congress enacted a subsidized program in the first place, continue to exist.

<u>Urban Property Protection and Reinsurance Program</u>

The riot reinsurance program was enacted as a response by Congress to the unavailability of property insurance in central city areas following the urban riots in the mid to

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* 42 USC §4015(b)(2)

late 1960s. Congress recognized that insurance availability problems would continue if private insurers were concerned about concentration of urban property exposures and uncertain of the availability of private reinsurance.

The legislation established conditions that were to be met in assuring residents and businessmen basic property insurance coverage through state administered FAIR plans, but the 1968 Act did not interfere with the state ratemaking process or the prerogatives of individual insurers to exercise sound underwriting judgments. The American Insruance Association not only enthusiastically supported the 1968 legislation, but its companies were in the forefront in purchasing federal riot reinsurance.

Through the FAIR plans and directly, insurers have made significant amounts of insurance available in urban areas. Since inception of the program, some three million FAIR plan policies have been issued to residents and businessmen in the 28 states with FAIR plans. $1.8 billion in claims have been paid to FAIR plan insureds. FAIR plans have paid out almost $500 million more than they have received in premiums and investment income.

Unlike the federal flood insurance program, there has never been a subsidy of federal riot reinsurance premiums. Rates were to be set on the basis of the actual exposure of the federal government. From the beginning, the federal reinsurance rate took into consideration the existence of a state obligation to share in the federal losses, as well as the right of the FIA to assess private insurers (in addition to their premium payments), for a certain level of federal losses.

[illegible]

Not only has the federal government never subsidized private insurers in the sale of riot reinsurance, but after payment of losses and expenses, the government actually realized a surplus of more than $120 million from the sale of such coverage. Private insurers have thus paid full price for the services of federal reinsurance.

Currently, however, only 34 reinsurance contracts have been entered into with FIA by private insurers, a fraction of the number in past years. Despite the fact that since the program began, AIA companies were the leading purchasers of the federal coverage, only one of 150 AIA companies has indicated that it purchased it this year. The primary reason for this drop in industry interest in federal reinsurance is the ten-fold rate increase by FIA for the 1981 contract year. As the AIA predicted in its testimony before this Committee last year, there is little interest in a program with unrealistically high premium rates.

At 25¢ per $100 of coverage, the FIA rate is grossly excessive, has no relation to actual past or anticipated future riot losses, and few insurers are willing to pay such a price when private riot reinsurance is available at substantially lower cost. In fact, FIA does not even claim that the 25¢ rate is needed to cover expected riot losses, but has set that rate to produce a surplus to fund the losses generated by the entirely separate Federal Crime Insurance Program.

At this time, the entire $120 million that was realized as profit from the sale of riot reinsurance to private insurers has been used up by the FIA to pay crime losses. There are no reserves left to cover future federal responsibilities for riot

losses. If such losses occur, these costs will have to be funded, at least initially, by borrowing from the Treasury, and the potential exists for assessments against insurers who remain in the program. Not only has this development reduced the soundness of the federal program, but it adds another disincentive to continued insurer participation.

Today, private market riot reinsurance is readily available at reasonable cost and few companies can be expected to purchase federal coverage that is excessively priced. Furthermore, insurers believe that they are better prepared today to respond in an orderly fashion following an outbreak of serious rioting.

Accordingly, despite the past success of the federal riot reinsurance program in encouraging the availability of essential insurance in urban areas, many AIA companies do not believe that federal riot reinsurance is needed at this time. Nevertheless, the AIA Board of Directors has not yet had an opportunity to vote on whether to change its position from that taken last year when the AIA was the only insurer group to testify in favor of continuation of the federal riot reinsurance program.

The AIA Board of Directors will consider this issue on April 7, and its position will be conveyed to this Committee. Among the options that the Board will consider will be extension or termination of the program, and as a third alternative, suspension of the program so that it could be promptly reinstituted in the future if the need arises.

Federal Crime Insurance

In enacting the Federal Crime Insurance Program in 1970, Congress acknowledged that crime losses in certain urban areas were as uninsurable as those from floods.

The 1970 Federal Insurance Administration Report, which preceded the Congressional action, found that:

> "The choices we have as a society are not easy. We must decide not only whether we want to save our urban areas, but also whether we are willing to pay the price. This report demonstrates that traditional insurance approaches are inappropriate to the problem of crime losses in the areas most seriously affected. It is impossible for the residents of these areas to bear the full financial burden of either their uninsured losses or their own insurance costs as traditionally determined under the rating laws of the several States. If we are to compensate these residents for crime losses, the cost of this compensation must in part be borne by others."*

Following issuance of that report, Congress chose not to rely on state solutions to the problem, and developed a direct federal program to compensate crime losses. As with federal flood insurance, there were no illusions that the program would be self-sustaining, and Congress decreed that premiums were to be "affordable", rather than actuarially sound, so that residents and businessmen in high crime areas could purchase the coverage. While it was intended that in the early years of the program costs would be advanced from the riot reinsurance surplus in the National Insurance Development Fund (NIDF), it was understood that appropriations would ultimately be required. No

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* Report on Availability of Crime Insurance & Surety Bonds in Urban Areas, Federal Insurance Administration, U. S. Department of Housing and Urban Development, 1970, p. 3.

such appropriations were made and crime insurance losses have wiped out the more than $120 million surplus of the NIDF, which as of the end of FY 1981, showed a deficit of more than $7 million.

Despite extensive protective device requirements, which private insurers would find difficult, if not impossible, to enforce, the federal government has paid more than $3 in losses and expenses for every dollar of premium income--about $200 million has been expended against approximately $60 million in premium income. Nevertheless, such losses are consistent with the Congressional intent in enacting a program that was not true "insurance", but was a response to a social problem of such scope in certain states that private solutions were unlikely.

Nothing has changed in the last twelve years to bring the reasoning behind the premium structure of the 1970 Act into question. Excessive crime losses, concentrated in heavily populated urban areas would still require insurance premiums that, without a subsidy, would prove prohibitive, regardless of whether such coverage was sold by the federal government or by private insurers.

The federal government may choose to reevaluate its decision that the social problem of crime losses should be addressed by a government program, or that on a relative scale of values, crime insurance ranks sufficiently high to justify the costs that must ultimately be borne by the Treasury and the taxpayers. But the actual experience of the Federal Crime Insurance Program is devastating proof that compensation for losses from crime cannot be accomplished without a subsidy.

Program adjustments, including premium increases, may be warranted, but neither they nor increased deductibles nor stepped up enforcement of protective requirements will alter the basic need for subsidies in multiples of the premiums charged.

Undoubtedly, there are states in the Federal Crime Insurance Program where both number of insureds and losses are minimal enough for coverage to be provided through private or state mechanisms. However, in high crime areas where there is significant demand for the coverage, the magnitude of the exposure precludes private, non-subsidized solutions.

Insurers must base their rates on actual experience, and the private insurance mechanism is not structured to provide the extensive subsidies required by a social insurance program. As long as government desires an "affordable" premium structure to insure against a severe social problem, the federal crime insurance program is the most appropriate method for providing crime insurance to high risk insureds.

The American Insurance Association has supported the federal flood, riot and crime insurance programs since their inception. Whatever approach is taken on the continuation of these programs, the AIA and its companies will continue to work with the Congress and the Administration to help make essential insurance coverages available.

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April 19, 1982

Honorable Henry B. Gonzalez
Chairman
Subcommittee on Housing and
Community Development
U. S. House of Representatives
Washington, D. C. 20515

Dear Chairman Gonzalez:

On April 1, 1982, in my testimony on behalf of the American Insurance Association (AIA), I indicated that the AIA Board of Directors would meet on April 7 to determine the Association's position on extension of the federal riot reinsurance program.

As I testified, private market riot reinsurance is currently available at reasonable cost and as insurers believe that they are better prepared today to respond in an orderly fashion following an outbreak of serious rioting, few companies can be expected to purchase the federal coverage when it is excessively priced as it is today.

Nevertheless, over the years, the federal riot reinsurance program has succeeded in encouraging the availability of essential insurance in urban areas and despite the drop in the number of insurers that are purchasing the federal coverage, the AIA believes that the continued existence of the program is necessary.

Accordingly, the AIA Board of Directors, at its April 7 meeting, voted to support continuation of the program.

Many insurers, particularly smaller ones, still purchase federal riot reinsurance and the AIA would not deny them the opportunity to retain this security. Moreover if circumstances change, and if federal riot reinsurance again becomes critical, as it did in 1968 it would seem unwise to terminate the program only to have to seek new legislation to resurrect it.

Under the existing legislation, no insurer is required to purchase the federal coverage, and its availability is unlikely to impose financial costs on any insurer that chooses to obtain its riot reinsurance only in the private market. Those insurers that oppose the program are free to ignore it without penalty or burden.

Furthermore, the cost to the federal government of retaining the program is minimal. Since inception in 1968, total program expenses have been only $4 million. Against these costs, the government has netted $120 million over the life of the program, even after payment of all reinsured losses.

The advantages of continuing the federal riot reinsurance program impel the AIA to urge extension by the Congress.

I request that this letter be made a part of my testimony.

Thank you.

Sincerely,

George K. Bernstein

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Because [illegible]

Its elimination will not have an adverse effect on the general availability of property insurance in urban areas.

When we appeared before this subcommittee on April 7, 1981, we predicted that a large number of primary insurers would not continue to purchase the reinsurance from the Federal Government.

We understand that today only 98 insurance companies purchase the reinsurance, whereas there were 300 companies buying the protection during the previous contract year.

In our opinion, the riot reinsurance program is an outstanding example of a Federal program which can be terminated without loss of services or benefits to the community.

The only justification for Federal involvement in providing insurance protection is when such coverage is essential or when it is not readily available in the private insurance market. Neither condition exists today.

Our members have taken into consideration the socioeconomic condition of our depressed economy. They understand that predictions have been made concerning the possibility of civil disturbance arising during a hot summer.

In spite of this, our members have reexamined the market situation and made a positive business decision that Federal riot reinsurance is a program that has outlived its usefulness and is no longer needed.

FEDERAL CRIME INSURANCE PROGRAM

The Federal crime insurance program was established under the 1968 Urban Property Protection and Reinsurance Act.

The act authorized the Federal Government, as an insurer, to provide crime insurance at an affordable price in any State that has a critical crime insurance availability problem and does not have an appropriate State program to provide a solution.

The crime insurance program became effective August 1, 1971. This program should not be reauthorized for fiscal year 1983.

The availability of crime insurance is not a national problem but an individual State problem.

The bulk of the policies have been issued in New York, Pennsylvania, Florida, and Massachusetts. Approximately 71,000 policies are currently in force in 30 jurisdictions with 60 percent of the policies issued in New York.

In a State where a crime insurance availability problem has been demonstrated, a solution to the problem should be tailor-made to meet the needs of consumers for that State.

We are willing to help establish an effective program in those communities where a problem exists and are committed to working with State administrations toward this end.

NATIONAL FLOOD INSURANCE PROGRAM

The Alliance has been a strong and diligent supporter of the national flood insurance program. Its members were most active in helping set up the program prior to its enactment in 1968.

Following enactment, we urged our member companies to fully support the development of the program, to promote the sale of

flood insurance policies, to offer claims and other service expertise and to participate with Government as risk-sharing partners.

During the first 10 years of its existence—1968–78—the national flood insurance program operated as a partnership between private industry and the Federal Government.

In spite of the success of the cooperative program, the Federal Insurance Administration, for reasons of its own, decided to dissolve the partnership. FIA began to operate the program unilaterally on January 1, 1978, predicting that they could do it cheaper and better without private industry involvement.

However, this has not proven to be true.

The present administration has indicated an interest in renewing the prior Government/industry partnership. The Alliance has been asked to participate in an effort to help make the national flood insurance program operate on a more businesslike basis.

The goal of the Federal Insurance Administrator is to minimize direct Federal involvement in the program.

FIA has sought input from the Alliance as to alternatives which would improve the present operation of the program.

The objective is to identify problems in the present operation of the program so that steps can be taken to mitigate as many of the present problems as possible, thereby creating a climate in which the Alliance, and other segments of the insurance industry, could participate.

Mr. Chairman and members of the subcommittee, we thank you for this opportunity to present our views. I will be pleased to answer questions.

[Mr. Jones' prepared statement, on behalf of the Alliance of American Insurers, follows:]

TESTIMONY OF THE

ALLIANCE OF AMERICAN INSURERS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

AT OVERSIGHT HEARINGS ON THE REAUTHORIZATION

OF THE

URBAN PROPERTY PROTECTION AND REINSURANCE ACT

AND

NATIONAL FLOOD INSURANCE ACT

JAMES E. JONES, JR.

APRIL 1, 1982

Mr. Chairman and Members of the Subcommittee, my name is James E. Jones, Jr., and I am the Government Affairs Representative for the Alliance of American Insurers. The Alliance is a major national trade association of more than 150 property and casualty insurance companies. Our members provide both personal and commercial forms of insurance protection in all 50 states and the District of Columbia.

We appreciate this opportunity to testify during the Banking Subcommittee's 1982 legislative hearings on the three Federal Insurance Programs administered by the Federal Insurance Administration.

I. <u>The Urban Property Protection and Reinsurance Act of 1968 (Federal Riot Reinsurance Program)</u>

Mr. Chairman and Members of the Subcommittee, the Alliance has appeared before this Subcommittee on several occasions to express our views concerning the reauthorization of the Federal Riot Reinsurance Program. We have stated, in good consciousness, that the Federal Program was not needed and strongly urged this Subcommittee not to reauthorize the Program. Our position has not changed during this period. In fact, today we are more convinced than ever that this Federal Program should be terminated.

The Urban Property Protection and Reinsurance Act of 1968 authorized the Federal Government to sell riot reinsurance to private insurance companies following the mid-1960's urban riots. The Act assured that essential property insurance would remain available in the urban areas, and other areas of the state, suffering from an inadequate property insurance market. The national advisory panel established by President Johnson in 1967 to study the problem of insurance availability in the riot affected areas of our cities concluded that a joint government/private industry program was needed. The Alliance, at that time, strongly supported that decision.

The Federal Riot Reinsurance Program has been in effect for 14 years. It has been a highly successful joint venture among private industry, state and Federal Governments. The Program has not necessitated any Federal funding to date. All the claims which have been paid from inception of the Act by the Federal Riot Reinsurance Program have come out of reinsurance premiums collected from participating insurers. In fact, premiums collected by the Federal Government at one time exceeded losses paid by approximately $140 million. It should be noted, however, that the Federal Insurance Administration has used this reserve to pay for the growing operating losses arising from the Federal Crime Insurance Program, and that this reserve is now depleted.

Insurers who participated in state pooling arrangements known as FAIR (Fair Access to Insurance Requirements) Plans were qualified to purchase the

Federal Reinsurance. FAIR Plans have been successful from a public policy standpoint in that they have provided the basic property insurance necessary for the reconstruction of our cities. They have also become an intricate part of the insurance market network. Some of the Plans have extended considerably beyond just providing essential insurance and are now offering to urban residents a choice of insurance coverages similar to that available in the voluntary market. The Plans in Illinois, Massachusetts, Rhode Island, Wisconsin and Ohio now issue a homeowners package policy.

As previously mentioned, the availability of Federal Riot Reinsurance was essential to the establishment of FAIR Plans. Today, however, market conditions have vastly changed. Private reinsurers have returned to the urban riot and civil commotion market. In fact, there is ample private reinsurance capacity today so that no primary insurers need to turn to the Federal Government for such a market. In our opinion, the service and benefits provided by the Federal Program can now best be provided through the private reinsurance market.

Because of the already reduced role, and the expectation on our part of further attrition of the Program through market forces in the coming months, we again urge that this Program be terminated. Its elimination will not have any adverse effect on the general availability of property insurance in urban areas. This assertion is based in part on a poll of Alliance members which we conducted several years ago. Our member companies tell us that reinsurance is indeed necessary for them to insure urban high risk areas. However, such reinsurance can be purchased through the private reinsurance market on terms and at a cost more favorable than the existing Federal Insurance Program. Furthermore, primary insurance can be made available, at

reasonable cost, to homeowners and small businesses in inner city areas through the FAIR Plans even if Federal Riot Reinsurance is no longer available.

The continuation of state FAIR Plans is not dependent on the existence of the Federal Riot Reinsurance Program. There has not been an attempt to discontinue the operation of these state Plans in any of the nine states which no longer qualify under the Act.

All of the FAIR Plan states except three (Georgia, Maryland and Pennsylvania) have adopted legislation which assures that the Plans will continue to exist independently of the Federal Act and efforts are now being made in these three states to enact such legislation.

When the riot reinsurance reserve fund became exhausted, the FIA, on October 1, 1981, increased the premiums from $.025 per 100 to $.25 per 100. This amount, we believe, exceeds the rate charged by private reinsurers and has led to a dramatic shift by private insurers away from the Federal Insurance Program. When we appeared before this Subcommittee on April 7, 1981, we predicted that a large number of primary insurers would not continue to purchase the reinsurance from the Federal Government if the rate were increased. We understand that today only 98 insurance companies purchase the reinsurance, whereas there were 300 companies buying the protection during the previous contract year.

The Administration has made it clear that it wants to terminate those programs which have become redundant or those whose purpose can best be accomplished through reliance on the private sector. In our opinion, the Riot Reinsurance Program is an outstanding example of a Federal Program which can be terminated without loss of services or benefits to the community. <u>The only justification for Federal involvement in providing insurance protection</u>

are when such coverage is essential or when it is not readily available in the private insurance market. Neither condition now exists!

Our members have taken into consideration the socio-economic condition of our depressed economy. They understand that predictions have been made concerning the possibility of civil disturbances arising during a hot summer. In spite of this, our members have re-examined the situation and made a positive business decision that Federal Riot Reinsurance is a program that has outlived its usefulness and is no longer needed.

II. Federal Crime Insurance Program

The Federal Crime Insurance Program was established under the 1968 Urban Property Protection and Reinsurance Act. The Act authorizes the Federal Government, as an insurer, to provide crime insurance at an affordable price in any state that has a critical crime insurance availability problem and does not have an appropriate state program to provide a solution. The crime insurance program became effective August 1, 1971.

The Alliance, in previous appearances before this Subcommittee, did not take a position on the reauthorization of the Program. We understand that now the Administration has taken the position that the Program should not be authorized for FY'83. We support this decision of the Administration.

In our opinion, the Federal Crime Insurance Program has not been a success and is a "social program" rather than an insurance program. The Program is subsidized by the Government in order for the premium to be affordable as required under the statute. To continue the Program, under this condition, a $50 million appropriation is required.

The lack of availability of crime insurance is not a national problem but an individual state problem. The bulk of the policies have been issued in New York, Pennsylvania and Florida. Approximately 77,000 policies are currently in force in 30 jurisdictions with 60 percent of the policies issued in New York.

In a state where a crime insurance availability problem has been demonstrated, a solution to the problem should be "tailor-made" to meet the needs of consumers for that state. We are willing to help establish an effective program in those communities where a problem exists and are committed to working with state administrations toward this end.

III. National Flood Insurance Program

The National Flood Insurance Program was established under authority of the National Flood Insurance Act of 1968. It is a subsidized, Government-supported program designed to help owners of real or personal property in areas designated as eligible for flood insurance, purchase such insurance.

The Alliance has been a strong and diligent supporter of the National Flood Insurance Program. Its members were most active in helping set up the Program prior to its enactment in 1968. Following enactment, we urged our member companies to fully support the development of the Program, to promote the sale of flood insurance policies, to offer claims and other service expertise and to participate with Government as risk-sharing partners. Today, we urge reauthorization of the National Flood Insurance Program.

During the first ten years of its existence (1968-78), the National Flood Insurance Program operated as a partnership between private industry and the Federal Government. In spite of the success of the cooperative program, the Federal Insurance Administration, for reasons of its own, decided

to dissolve the partnership. FIA began to operate the Program unilaterally on January 1, 1978, predicting they could do it cheaper and better without private industry involvement. However, this has not proven to be true.

Abrupt termination of the agreement between FIA and private companies created extensive dislocation among companies which, in good faith, had established special servicing units. Many employees had to be terminated. The government action was very costly to participating companies.

The present Administration has indicated an interest in renewing the prior government/industry partnership. The Alliance has been asked to participate in an effort to help make the National Flood Insurance Program operate on a more businesslike basis. Our member companies have carefully considered the Federal Insurance Administrator's invitation to enter into discussions to explore the feasibility of renewed industry participation in the operation of the Program. Our members are willing to enter into such discussions under the following conditions:

- Agreement must be reached which provides that termination of a contractual agreement between industry and Government must be subject to prior Congressional approval and not at the discretion of the Administrator.
- The Flood Insurance Program must undergo a complete, non-government audit by a well recognized auditing firm.

It must be recognized that private insurers will need to be satisfied that whatever investments they would make to reconstitute a government/industry flood insurance partnership, would be for the long term. To establish the servicing facilities necessary to gear up for participation in the program would be expensive. Alliance members would thus want assurance, in advance, that termination of any new partnership would not be allowed to occur without

good cause. Our members feel that the original contract was terminated without good cause and they would not want history to repeat itself. No one disputes the right of Government to terminate a contractual relationship with private industry if there are good reasons. What our member companies object to is the termination of a contract at the whim of an administrator. For this reason, our members feel that it is essential that the Federal Insurance Administration agree to an amendment to the Act which would require prior Congressional approval of the termination of any new agreement.

Because private industry has been totally excluded from participation in the Flood Insurance Program since January 1, 1978, it is only reasonable to require an independent audit if private insurers are going to consider returning to the Program as risk-bearers. It is a common sense business practice to require a full and impartial audit of any program in which one contemplates a major financial investment.

The goal of the Federal Insurance Administrator is to minimize direct Federal involvement in the Program. In this regard, FIA hopes to encourage participation by the private insurance industry in one or more potential alternatives which would improve the Program. FIA has sought input from the Alliance as to alternatives which would improve the present operation. The objective is to identify problems in the present operation of the Program so that steps can be taken to mitigate as many of the problems as possible, thereby creating a climate in which the Alliance, and other segments of the insurance industry, could participate and eventually make possible less direct government involvement.

Mr. Chairman and members of the Subcommittee, this concludes our prepared statement. Again, we thank you for this opportunity to present our views. I will be pleased to answer questions.

Chairman GONZALEZ. Thank you very much, Mr. Jones.
Mr. Shamberger.

STATEMENT OF JAMES M. SHAMBERGER, SENIOR VICE PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. SHAMBERGER. I am James Shamberger, senior vice president of the Reinsurance Association of America.

The Reinsurance Association of America is a trade association representing professional property and casualty reinsurers in the United States.

Reinsurance is a transaction whereby one insurer assumes all or part of a risk originally undertaken by another insurance company.

In the context of today's hearing, a reinsurer often protects the ceding insurer against losses in excess of an agreed-upon amount per risk or protects the ceding insurer against an accumulation of individual losses from a single event, or both.

As has been noted previously, the Urban Property Protection and Riot Reinsurance Act of 1968 was enacted following the widespread social disturbances of the 1960's.

The program authorized the Federal Government to offer riot reinsurance to insurers in jurisdictions which enacted laws assuring the availability of property insurance for those unable to obtain it in the private market.

In many cases, however, State legislatures elected not to participate in the program or meet Federal requirements. Federal riot reinsurance has not been available in those jurisdictions.

Even in those States in which the Federal Government now offers riot reinsurance, most primary insurers do not participate in the program. Insurers doing business there have concluded that adequate protection is available from the private reinsurance market at a reasonable rate.

The association is asked from time to time to compare the price and coverage available in the private market with the Federal program.

It is difficult, if not impossible, to make such a comparison. No private reinsurer offers coverage identical to the Federal contract.

The narrow structure of the program and the low level at which Federal payments are provided are the most obvious distinctions between the structure of Federal and private reinsurance.

These differences in the method by which coverage is obtained in the Federal program, as contrasted to the private market, make it impossible to compare rates.

It is clear, however, that adequate reinsurance is readily available in the private market at reasonable rates. This has been the case for several years, but reinsurance markets at the present time are more competitive and prices are lower than ever seen by many reinsurers.

This availability in the private sector, as well as the 10-fold rate increase in the Federal program, explains the mass exodus of more than two-thirds of the companies previously participating.

The Reinsurance Association of America recommends that the program not be extended. While it is impossible to guarantee un-

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limited capacity or state unequivocally that future availability will always be adequate in the private market, present circumstances demonstrate that the Federal program is no longer needed.

[The prepared statement of the Reinsurance Association of America, presented by Mr. Shamberger, follows:]

STATEMENT OF THE

REINSURANCE ASSOCIATION OF AMERICA

CONCERNING THE

FEDERAL RIOT REINSURANCE PROGRAM

The Reinsurance Association of America is a trade association representing professional property and casualty reinsurers in the United States. Reinsurance is the business of one insurer assuming all or part of a risk originally undertaken by another insurance company. A professional reinsurer is an insurance company which has as its principal activity the writing of reinsurance and is to be contrasted with insurance companies which directly insure the general public. The RAA's member companies assume more than $4 billion of gross reinsurance premiums annually.

The origin of the Urban Property Protection and Riot Reinsurance Act of 1968 lies in the widespread social disturbances of the 1960's. During that period, these serious conditions and uncertainties raised questions as to the continued availability of property insurance in urban areas. The Congress responded with the enactment of a program which authorized the federal government to offer riot reinsurance to insurers in those jurisdictions which enacted laws assuring the availability of property insurance for those unable to obtain it in the private market. In many cases, state legislatures elected not to participate in the Program or meet federal requirements. Federal riot reinsurance has not been available in those jurisdictions.

Even in those states in which the federal government now offers riot reinsurance, most primary insurers do not participate in the Program. In those cases insurers have concluded that adequate protection, competitively priced, from the private reinsurance market is available. Moreover, many reinsurers believe that the Program is unnecessary or improperly structured.

Requests have been made at times to compare riot reinsurance coverage available in the private market with the federal Program. It is difficult to make such a comparison because no private reinsurer offers coverage identical to the federal contract. The federal program can be described as an aggregate excess of loss reinsurance treaty providing coverage on specific lines of insurance; such as fire and extended coverage, other allied lines of fire insurance, and burglary and theft for losses arising from defined conditions of civil disorder in excess of a predetermined retention based on a company's previous year's premiums in each state. A company's aggregate retention in each state is five percent of direct premiums earned for covered lines in that state with a $1,000 minimum. Thus, in the case of an insurer having earned premiums of $1 million in a state, the retention would be only $50,000. Above this level, the federal plan could pay at least 90 percent of all losses incurred in the state resulting from the event.

In contrast, the private reinsurance market offers an excess of loss treaty providing protection against losses in excess of a predetermined retention per risk resulting from a

number of perils, including riots. In the private market retentions are not determined on a state-by-state basis. Instead, an insurer's retention will be determined by its total capacity to retain a portion of the risk. The private market also offers catastrophe cover to protect primary insurers from the accumulation of individual losses arising from a single event.

These disparities in the method by which coverage is obtained in the federal Program as contrasted to the private market make it impossible to compare rates. However, it is clear that adequate reinsurance is readily available in the private market at reasonable rates. This availability in the private sector explains the mass exodus from the federal Program this year of more than two-thirds of the companies previously participating. This withdrawal has resulted in a reduction in coverage in force in the federal Program of eighty-eight percent from the last contract year, even though the number of participating states increased.

The Federal Riot Reinsurance Program was introduced because the coverage was thought to be unavailable in the private market although it was presumed needed to make necessary property insurance coverage available. To the credit of all involved, most states enacted FAIR plans to provide essential property coverage at reasonable rates. Today the states and the insurance industry are committed to the continuation of essential property insurance through FAIR plans.

Whether truly needed at the time or not, the Federal Riot Reinsurance Program served as a catalyst for the creation of these essential insurance mechanisms. It is important to know, however, that the existence of the Federal Riot Program is not a legal or economic condition for the continuation of these FAIR plans. Moreover, there is no evidence that property insurance availability is enhanced by the presence of the Federal Riot Reinsurance Program. In fact, the mere showing that only a small fraction of the qualifying companies buy the federal coverage is ample evidence that it does not affect coverage in today's marketplace.

In conclusion, the Reinsurance Association of America recommends that the Federal Riot Reinsurance Program not be continued beyond its current expiration date of September 30, 1982. While it is impossible to guarantee unlimited capacity or state unequivocally that future availability will always be adequate in the private market, present circumstances demonstrate that the federal Program is no longer needed to assure availability of essential property coverage.

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Chairman GONZALEZ. Thank you very much, Mr. Shamberger. Mr. Fritzel.

STATEMENT OF CHARLES H. FRITZEL, ASSISTANT VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. FRITZEL. Thank you, Mr. Chairman.

For the record, my name is Charles Fritzel. I am the assistant vice president for Government relations of the National Association of Independent Insurers, a voluntary national trade association of over 500 insurers.

I will ask that our prepared statement be submitted for the record and I will summarize our remarks.

NAII favors the termination of the Federal riot reinsurance program and the Federal crime insurance program. We support a viable national flood insurance program and commend the recent actions by the Federal Insurance Administration to put the program on a more businesslike basis.

We believe that the need for the Federal riot reinsurance program no longer exists. Simply put, market conditions have caught up with the program.

As Mr. Bernstein, Mr. Shamberger and Mr. Jones said, the rate increase which the Federal Insurance Administration put in place last October has made it competitive with the private market and insurers are no longer purchasing the Federal reinsurance.

Reinsurance in force in the Federal program today is about 88 percent less than a year ago. The fact that so many insurers, even after congressional action last year in repealing the Holtzman amendment, have not purchased Federal reinsurance this year, demonstrates that the program has served its purpose and need not be renewed.

The ability of State regulators to assure the availability of property insurance through fair plans and the ability of private reinsurers to provide backing for insurers participating in the FAIR plans is now a fact.

The Federal crime insurance program is not insurance. It is a subsidy to businesses and residents in high-crime areas. Last year it lost nearly $33 million.

Since its inception in 1970, the program has lost nearly $170 million. The program can hardly be called national in scope.

About 71,000 policies currently are in force nationwide. Roughly 60 percent of these are written in New York State—about 42,000 policies.

The next highest State is Pennsylvania, with about 5,000 policies, then Florida, with about 4,000, then Massachusetts, with 2,800.

Roughly 75 percent of the program's coverage is written in four States. It is our understanding that the Federal Insurance Administration has recommended termination of the program. We support that position.

NAII is willing to work with the New York State insurance authorities in developing a State program to replace the Federal one. Insurance is a State-regulated business and because we believe in State regulation and because so much of the program is written

New York, we think it is better left to the State and insurers doing business there to solve this problem.

In 1977, the Federal Government took over the operation of the national flood insurance program, which until then had been a cooperative effort with private insurance industry participation.

In the 4 years the Federal Government has run the program, we have had little contact with it. NAII supports a strong and viable national flood insurance program and favor its renewal.

We applaud the efforts of Federal Insurance Administrator Jeffrey to put the program on a more business-like basis and look forward to assisting him in that effort.

That concludes my statement.

[Mr. Fritzel's prepared statement, on behalf of the National Association of Independent Insurers, follows:]

STATEMENT OF
CHARLES H. FRITZEL
ASSISTANT VICE PRESIDENT FOR GOVERNMENT RELATIONS
NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
APRIL 1, 1982

My name is Charles H. Fritzel and I am the Assistant Vice President for Government Relations of the National Association of Independent Insurers (NAII).

NAII favors termination of the Federal Riot Reinsurance Program and the Federal Crime Insurance Program. We support a viable National Flood Insurance Program and commend the recent actions by the Federal Insurance Administration (FIA) to put the program on a more businesslike basis.

NAII is a voluntary national trade association of over 500 insurers. Our organization provides a truly representative cross section of the property and casualty insurance business in America. Our members range in size from the smallest one-state companies to very large national underwriters and consist of both stock and non-stock companies. NAII member companies reflect all forms of merchandising -- independent agency, exclusive agency, and direct writers and they include insurers which serve a general consumer market and those which specialize in serving particular consumer groups such as farmers, teachers, government employees, military personnel, and truckers.

Federal Riot Reinsurance

NAII believes the need for the Federal Riot Reinsurance program no longer exists. Simply put, market conditions have caught up with the program. In the past, the artificially low rate of 2.5 cents per 100 dollars of subject premium attracted many insurers to the program because it was below the private market cost. On October 1 1981 the Federal Insurance Administration (FIA) increased the reinsurance rate by tenfold to 25 cents per 100. This was done, in part to rebuild the riot reinsurance fund which had been diverted for payment of crime insurance losses. The effect of the rate increase was to make the program competitive with the private reinsurance market.

We understand that fewer than 36 insurance groups currently are purchasing the federal riot reinsurance, down from nearly 300 last year. Reinsurance in force in the federal program for this fiscal year is 88% less than the previous year.

The fact that so many insurers, even after Congressional action last year in repealing the Holtzman Amendment, have not purchased federal reinsurance this year, demonstrates that the program has served its purpose and need not be renewed. The ability of state regulators to assure the continued availability of property insurance through FAIP Plans and the ability of private reinsurers to provide backing for insurers participating in the FAIR Plans is now a fact. The Riot Reinsurance program has served its purpose and now need not be renewed.

Federal Crime Insurance Program

The Federal Crime Insurance program is not insurance. It is a subsidy to businesses and residents of high crime areas. Last year it lost nearly $33 million. Since its inception in 1970, the program has lost nearly $170 million.

The program can hardly be called national in scope. About 71,000 policies currently are in force nationwide. Roughly 60% of these are written in New York State -- about 42,000 policies. The next highest state is Pennsylvania with about 5,000 policies, then Florida with about 4,000, the Massachusetts with 2,800. Roughly 75% of the program's coverage is written in just four states.

It is our understanding that the Federal Insurance Administration will recommend terminating the program. We support that position. NAII is willing to work with the New York state insurance authorities in developing a state program to replace the federal one. Insurance is a state regulated business and because we believe in state regulation and because so much of the program is written in New York, we think it is better left to the state and insurers doing business there to solve this problem.

National Flood Insurance Program

In 1977, the federal government took over the operation of the National Flood Insurance Program which, until that time, had been a cooperative effort with private insurance industry participation.

In the four years the federal government has run the program, we have had little contact with it. NAII supports a strong and viable National Flood Insurance Program and we favor its renewal. We applaud the efforts of Federal Insurance Administrator Jeffrey Bragg to put the program on a more businesslike basis.

Mr. GONZALEZ. Thank you, Mr. Fritzel.

Let me say for the record that Mr. Hunter has a distinguished record of public service, and particularly in this area.

He headed the Federal Insurance Administration, and in my opinion, did a tremendous job. We still remember you with a great deal of gratitude and welcome you in your capacity as representative of the organization that you represent now.

STATEMENT OF J. ROBERT HUNTER, PRESIDENT, NATIONAL INSURANCE CONSUMER ORGANIZATION

Mr. HUNTER. Thank you, Mr. Chairman. I appreciate your remarks. I will summarize my remarks, if my full statement could go into the record.

Chairman GONZALEZ. Without objection, sir.

Mr. HUNTER. Regarding flood insurance, it is a pleasure to testify at a hearing where the extension of the flood insurance program is the least controversial proposal. I fully support its continuation. The controversy that exists in the program that demands your review is the direction that FIA has embarked upon in the program. As I understand it, they wish to eliminate the Federal subsidy by 1988 and more fully involve the private sector.

While raising rates fairly and gradually to lower taxpayer costs is a concept we can all endorse, to eliminate the flood insurance subsidy by 1988 will prove either impossible or, if realized, catastrophic. To achieve it would be a breach of faith with those communities that enacted, often under great pressure, the flood plain management standards. It would be a breach of faith with those living in flood plains who count on the program's affordable rates and complete coverage. Coupling the requirement on lenders to require flood insurance with insurance suddenly becoming unaffordable will force lenders to call mortgages and thus drive people from their homes. This cannot be tolerated.

Not only that, it is obvious that a good part of FIA's strategy to eliminate taxpayer subsidies by 1988 is predicated upon jacking up the deductible to high levels. This has already begun. Now here is a shell game if ever there was one. First of all, the casualty loss under the higher deductible is available for tax writeoffs; and who pays for that? The taxpayer. Second, the below the deductible costs are—foolishly, I think—eligible for disaster relief; and who pays for that? The taxpayer. Thus these savings for taxpayers are largely illusory.

Worse, perhaps, is the potential this scheme has for undermining the program's support. If people and communities see this as a breach of faith and developers seize upon this opportunity to kill the program, the big loser in the long run will be the very taxpayer that FIA claims to defend via lowered subsidies.

This potential danger requires your careful thought.

Regarding private involvement in NFIP, the private competitive insurance market should be actively involved in the program. Insurers should actively compete among themselves and with the servicer of the program for the actuarially rated business. Insurers should also advise the program regarding new insurance :h-

niques which might make the program work better for flood insurance buyers.

Insurers should also fully compete, company by company or in groups of companies, for the contract for the servicing of subsidized insurance. Noninsurance entities, such as EDS and others, should freely join in that competition. Since subsidized flood insurance will, over the long pull, pay out more in claims than it takes in in premiums, it is the taxpayer who bears the full cost of servicing the subsidized insurance program. Taxpayers deserve the assurance that only competitive bids give them that this cost is minimized, consistent with quality service.

However, if by "private sector involvement" the administration means to revive the old "partnership," I want to remind them that the last "partnership" with the National Flood Insurers Association [NFIA] collapsed.

Unless the issue of secretarial authority is settled by Congress, FIA should not reenter the expensive twilight zone of a partnership with insurers, funded by the taxpayer.

Turning to the Urban Property Protection and Reinsurance Act of 1968, it is my recommendation that you either extend the programs or legislate a responsible disengagement of both the Federal crime insurance program and the State FAIR plan requirements, while retaining the capability to provide riot reinsurance.

The need for a Federal riot reinsurance capability is obvious: Private reinsurers will sell affordable riot reinsurance as long as there are no riots—but no longer. The experience of the 1960's stands as stark evidence of this point. When riot reinsurance vanishes, private direct insurers flee the cities leaving communities without insurance which are communities without hope.

In these economic times, with unemployment and falling expectations leading to predictions we all pray do not come to pass, it would be foolish to abolish the Federal riot reinsurance capability.

Regarding crime insurance and FAIR plans, insurance has been federally regulated since 1944, when the Supreme Court found insurance to be interstate commerce. Congress had, and still has, several options regarding how to exercise that regulatory authority. For instance, Congress could:

One, fully apply the antitrust laws to insurance and impose SEC and FTC-type oversight, or

Two, exempt the insurance industry from antitrust laws and

(a) establish a new agency to regulate insurance;

(b) delegate some aspects of insurance to the States while retaining some federally;

(c) delegate regulation to the States under Federal standards and oversight; or

(d) delegate regulation to the States with essentially no standards and no oversight.

Congress, in 1945, selected the latter approach, in a rash test of the New Federalism, and has not reviewed the situation since, in any detailed or systematic way, except for a couple of GAO reports. Congress has, from time to time, on a piecemeal basis, analyzed and taken action in one area of insurance or another (the programs are discussing here today are examples) when State regulation

cannot cope in a way that is so obvious that it cannot be tolerated at the national level.

Do we need these Urban Programs now? The obvious answer is; you cannot make urban enterprise zones work without them, or something like them, in place. Certainly, the Congress has here established property insurance residual markets which have benefited America through, over 10 years, providing millions of essential insurance policies that would otherwise not have been available.

Yet, these programs, while performing their essential function, have institutionalized anticompetitive insurer behavior which deprives all of America of more efficient insurance systems.

In 1974 the FIA published a landmark work called "Full Insurance Availability." Its prime finding was:

> The keystone in the arch of deficiencies in the property insurance residual market—indeed within the total property and liability insurance market—is continuation of the absolute right of insurer underwriters to deny essential insurance to applicants without reason or for arbitrary and capricious reasons which are entirely subjective in nature and which may have more to do with the insurer's competitive moods, modes and postures than with the objectively determined loss-potential characteristics of the risks.

The report called for State action to eliminate FAIR plans, crime insurance plans, and other residual market mechanisms in favor of the full insurance availability [FIA] system under which:

> All insurance risks would be able to purchase insurance from the insurer of their choice and would not be forced into separate, less adequate and more costly FAIR plan * * * markets. Only five States for auto insurance and one for fire and homeowners have been able to overcome tremendous insurer lobbying against the concept.

THE URBAN PLANS: THEIR IMPACT ON COMPETITION

The availability of residual market mechanisms such as the FAIR plan and crime plan has thwarted meaningful price and service competition by easing the capability of insurance company substitution of selection competition for price and service competition through providing a convenient dumping ground for insurers to place redlined or other subjectively discarded applicants for insurance. This activity, and the widespread knowledge of it among the public, freezes the market, making shopping for insurance far less practiced than for most purchases.

Selection competition is a very abusive practice. If it were eliminated, the supply and demand sides would become balanced and competition among insurers in price and service would be greatly enhanced. If this were coupled with good insurance information, consumers could shop and act upon what was best for them. They cannot today.

One of the members of this committee, Representative LaFalce of New York, has wisely asked GAO to review the costs to America of many of the other noncompetitive activities insurers engage in under the McCarran-Ferguson Act's antitrust exemption, including: Cartelized ratemaking; establishment of retail level (agent's) prices by the wholesale level (the companies). Insurance is one of the few parts of the economy still acting under the fair trade ty anticompetitive situation; prohibition, under State law, of grou forming to purchase insurance at reduced rates (the "

group" laws prohibit even employers from offering employees low-cost, true-group auto insurance, for example).

In his best-selling new book, "The Invisible Bankers," Andrew Tobias finds that insurance is grossly inefficient, perhaps employing 1 million too many employees.

Mr. Tobias' book should be required reading for every Member of Congress.

The urban plans have redlining implications. In 1978, HUD reported that redlining by insurers was "widely practiced" and that it had an undeniable racial component. Lest you think redlining is now under control, I now hand up to you for the record a recent Washington Post article which details how Allstate will not write renter's insurance in D.C. unless someone is in the apartment 24 hours a day. Allstate will, graciously, allow you an occasional night out together or even a vacation. You are not allowed to both work, however, if you rent. You both can work if you own the house, however. I wonder if Allstate will also allow you to be out of the apartment long enough to go to the suburban Sears stores, which all have Allstate booths (none of the D.C. Sears stores have Allstate booths) to buy your Allstate policy.

NICO proposes that the Congress amend Public Law 15, the McCarran-Ferguson Act, to require, as a standard for continued delegation of regulation of the insurance business to the States, that States enact full insurance availability programs so that good risks, regardless of location or other subjective characteristics, could get insurance from the company of the customer's choice, thus making competition more effective. Good risks for fire insurance could be defined in terms of previous experience, compliance with fire codes, lack of arson history, an so on. For crime insurance, the definition could include locks and other anticrime devices.

Your proposal, Mr. Chairman, as embodied in H.R. 5731 may be an appropriate stopgap, since the only way I can see for Congress to terminate these important programs without leaving 70,000 crime insurance policyholders and a like number of FAIR plan policyholders in Maryland and Georgia—which States' FAIR plans automatically terminate if riot reinsurance ends—out in the cold is to create the climate where State systems will serve all of the legitimate insurance needs of America through the private, competitive market.

This reform would enhance competition in price and service by eliminating selection competition for those risks qualifying under the good risk category. It is my belief that tens of billions of dollars will be saved if Congress would simply require insurers to deal for good risks, as Congress defines that term, and if the National Insurance Consumer Organization, the States, and others continue to develop needed consumer shopping guides to fill the current information void.

Please think, if you will, of today's economy, crying out for more productivity and lower out-of-pocket consumer cost; think of the insurance industry's gross inefficiency, gobbling up—like PAC-MAN—almost 12 percent of the Nation's disposable income, yet paying back less than 50 cents for every dollar of income. Think of this mammoth industry, free of antitrust law application or any

Federal oversight, running loose in our economy lobbying you to death with consumer-supplied money; think of the anticompetitive behavior in which insurance companies engage; think of the delegation of regulation Congress made to the States in 1945 without standards for performance and without continuing oversight; think of the GAO's finding that there are serious shortcomings in State laws and regulatory activities with respect to protecting the interests of insurance consumers in the United States. Think most of all of the citizens in our cities who are redlined and dumped into the FAIR plan, crime, and other residual markets, or even into no market at all where these plans do not exist.

If you think of these things, and I believe that you must, you will not simply terminate or simply extend these important urban programs. Rather, you will adopt the readily available alternative of making this industry more competitive, more efficient, and more responsive to America's essential insurance needs through adoption of one simple standard: that insurers deal with insurable risks as a condition for continued State regulation of insurance under the McCarran-Ferguson Act.

NICO will be happy to work with your staff on drafting the necessary amendment to accomplish this. Thank you.

Chairman GONZALEZ. Thank you very much for that offer, and we probably will have some staff consultation.

[The prepared statement of Mr. Hunter follows:]

NATIONAL INSURANCE
CONSUMER ORGANIZATION

Statement of

J. Robert Hunter, President
National Insurance Consumer Organization

before the

Subcommittee on Housing and Community Development
of the
Committee on Banking, Finance and Urban Affairs

US House of Representatives

April 1, 1982

344 Commerce Street
Alexandria, Virginia 22314
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Mr. Chairman and Members of the Committee, it is my pleasure to be here today to discuss with you the programs of the Federal Insurance Administration (FIA).

Flood Insurance

It is indeed unusual for me to testify in a hearing where extension of the flood insurance program is the least controversial proposal. I fully support its continuation.

There is controversy in the program, however, that demands careful Congressional review, and that is the direction that FIA has embarked upon in the program. As I understand it, FIA wants to eliminate the federal subsidy by 1988 and wants to more fully involve the private sector in the program.

Elimination of Flood Insurance Subsidy by 1988

In enacting the National Flood Insurance Program, Congress carefully and thoughtfully designed a long-range plan to disengage the federal taxpayer from the sharply mounting costs of unwise flood plain occupancy. In return for subsidized flood insurance on existing structures and other federal support for construction and acquisition of structures in high flood risk areas, Congress required safer construction within federally designated flood-prone areas.

The quid pro quo has worked. Over 17,000 communities are now enforcing flood plain management's minimum land use controls; nearly 2 million policies of insurance are now in force.

New structures built in flood plains in regular program communities are built much more safely and pay full actuarial rates for insurance (of all the

insurance sold in all flood-prone communities, nearly 90% is in regular program communities). Over time, as the existing inventory of structures in flood plains is literally or figuratively flushed out of the nation's housing inventory, and as new construction occurs, the proportion of the insured population paying full rates will increase, until it becomes possible to end all subsidies from taxpayers by adding a small surcharge to all policies written under the program. I project that that might possible as early as about 2010.

While raising rates fairly and gradually to lower taxpayer costs is a concept we can all endorse, to eliminate the flood insurance subsidy by 1988 will prove either impossible or, if realized, catastrophic. To achieve it would be a breach of faith with those communities that enacted, often under great pressure, the flood plain management standards. It would be a breach of faith with those living in flood plains who count on the program's affordable rates and complete coverage. Coupling the requirement on lenders to require flood insurance with insurance suddenly becomming unaffordable will force lenders to call mortgages and thus drive people from their homes. This cannot be tolerated.

Not only that, it is obvious that a good part of FIA's strategy to eliminate taxpayer subsidies by 1988 is predicated upon jacking up the deductible to high levels. This has already begun. Now here is a shell game if ever there was one. First of all, the casualty loss under the higher deductible is available for tax write-off; and who pays for that? The taxpayer! Second, the below the deductible costs are (foolishly, I think) eligible for disaster relief; and who pays for that? The taxpayer! Thus these "savings" for taxpayers are largely illusory.

Worse, perhaps, is the potential this scheme has for undermining the program's support. If people and communities see this as a breach of faith and

developers seize upon this opportunity to kill the program, the big loser in the long run will be the very taxpayer that FIA claims to defend via lowered subsidies.

This potential danger requires your careful oversight.

Private Involvement in NFIP

The private competitive insurance market should be actively involved in the program. Insurers should actively compete among themselves and with the servicer of the program for the actuarially rated business. Insurers should also advise the program regarding new insurance techniques which might make the program work better for flood insurance buyers.

Insurers should also fully compete, company by company or in groups of companies, for the contract for the servicing of subsidized insurance. Non-insurance entities, such as EDS and others, should freely join in that competition. Since subsidized flood insurance will, over the long pull, pay out more in claims than it takes in in premiums, it is the taxpayer who bears the full cost of servicing the subsidized insurance program. Taxpayers deserve the assurance that only competitive bids give them that this cost is minimized, consistent with quality service.

However, if by "private sector involvement" the Administration means to revive the old "partnership", I want to remind them that the last "partnership" with the National Flood Insurers Association (NFIA) collapsed.[1]

1. The breakdown in relations came about when NFIA refused to pay claims it was ordered to pay by Secretary Carla Hills (the claims denied were made by those who had, following a Corps of Engineers order to evacuate, moved their furnishings out of the path of a flood — thus incurring removal expenses.

In short, unless the issue of Secretarial Authority is settled by Congress, FIA should not reenter the expensive "Twilight Zone" of a "partnership" with insurers; funded by the taxpayer.

The Urban Programs

Turning to the Urban Property Protection and Reinsurance Act of 1968, it is my recommendation that you either extend the programs or legislate a responsible disengagement of both the Federal Crime Insurance Program and the State FAIR Plan requirements, while retaining the capability to provide riot reinsurance.

The Need to Retain a Federal Riot Reinsurance Capability

The need for a federal riot reinsurance capability is obvious: private reinsurers will sell affordable riot reinsurance as long as there are no riots -- but no longer. The experience of the 1960's stands as stark evidence of this point. When riot reinsurance vanishes, private direct insurers flee the cities leaving "communities without insurance (which) are communities without hope."[2]

---

1. (continued)
NFIA agreed that paying such claims would lower the overall program costs, but refused to pay on the grounds that it would be bad precedent for their privately written insurance contracts). A second point of concern HUD had was that NFIA had refused to competitively bid for servicing sub-contracts. Under the NFIA approach, sub-contracts were negotiated without competition the vast dollar bulk of which went to NFIA executive committee companies, which was effectively negotiating with itself.

Negotiations between HUD and NFIA were undertaken, the key stumbling block being NFIA's adamant refusal to accept HUD's authority over budget expenditures; following several years of negotiations between NFIA and HUD (under Presidents Ford and Carter), NFIA terminated the contract.

HUD then solicited competitive bids for servicing the program, under which NFIA refused to bid, preferring to mount a political and legal attack, both of which failed. EDS won the competitive bid, cutting NFIA costs about in half, prompting Senator Proxmire to award to then-Secretary Patricia Harris his rare "Golden Taxpayer Savings Award."

2. Meeting the Insurance Crisis of Our Cities — A Report by the President's National Advisory Panel on Insurance in Riot Affected Areas, 1968.

In these economic times, with unemployment and falling expectations leading to predictions [illegible], it would be foolish to abolish the federal riot reinsurance capability.

Crime Insurance and FAIR Plans

Riot reinsurance is made available only to insurance companies participating in FAIR (Fair Access to Insurance Requirements) Plans, which make essential property insurance available to those who can't buy it privately. This is as it should be conceptually: the government will assist the private sector if the private sector will assure the government of its willingness to provide essential services. Thus, as in flood insurance, the government has a valuable quid pro quo for its involvement.

FAIR plans exist in [illegible] states. They currently write essential insurance covering one million structures.

Crime insurance is sold directly to the public by the federal government in areas where there has been a finding of unavailability or unaffordability of private insurance. This program now protects over [illegible],000 homes and businesses. By what authority did Congress enact these programs?

Insurance has been federally regulated since 1944, when the Supreme Court found insurance to be interstate commerce.[1] Congress has, and still has, several options regarding how to exercise that regulatory authority. For instance, Congress could:

1) fully apply the antitrust laws to insurance and impose SEC and FTC-type oversight; or

1 United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944).

(2) Exempt the Insurance Industry from Anti-Trust laws and

(A) Establish a new agency to regulate insurance, or

(B) Delegate some aspects of insurance to the states while retaining some federally, or

(C) Delegate regulation to the states under federal standards and oversight, or

(D) Delegate regulation to the states with essentially no standards and no oversight.

Congress, in 1945, selected the latter approach (i.e., 2D)[4], and has not reviewed the situation since, in any detailed or systematic way, except for a couple of GAO reports. Congress has, from time to time, on a piecemeal basis, analyzed and taken action in one are of insurance or another (the programs we are discussing here today are examples) when state regulation can't cope in a way that is so obvious that it cannot be tolerated at the National level.

Do We Need these Urban Programs Now?

The obvious answer is: you can't make urban enterprise zones work without them, or something like them, in place. Certainly, the Congress has here established property insurance residual markets which have benefitted America through, over ten years, providing essential insurance that would otherwise not have been available. Many millions of policies have been issued under these programs.

Yet, these programs, while performing their essential function, have institutionalized anti-competitive insurer behavior which deprives all of America of more efficient insurance systems.

4. McCarran-Ferguson Act, PL 79-15, 59 Stat 33, 15 USC S 1011-1015 (1945).

In 1974, the FIA published a landmark work called Full Insurance Availability.[5] It's prime finding was:

> The keystone in the arch of deficiencies in the property insurance residual market — indeed within the total property and liability insurance market — is continuation of the absolute right of insurer underwriters to deny essential insurance to applicants without reason or for arbitrary and capricious reasons which are entirely subjective in nature and which may have more to do with the insurers competitive moods, modes and postures than with the objectively determined loss-potential characteristics of the risks.

The report called for state action to eliminate FAIR Plans, Crime Insurance Plans and other residual market mechanisms in favor of the Full Insurance Availability (FIA) System under which "all insurance risks would be able to purchase insurance from the insurer of their choice and would not be forced into separate, less adequate and more costly FAIR Plan . . . markets." Only five states for auto insurance and one for fire and homeowners have been able to overcome tremendous insurer lobbying against the concept.[6]

The Urban Plans: Their Impact on Competition

The availability of residual market mechanisms such as the FAIR Plan and Crime Plan has thwarted meaningful price and service competition by easing the capability of insurance company substitution of selection competition for price and service competition through providing a convenient "dumping ground" for insurers to place redlined or other subjectively discarded applicants for insurance. This activity, and the widespread knowledge of it among the public, freezes the market, making

5. Full Insurance Availability, Federal Insurance Administration (US Department of HUD), September, 1974.

6. MA, MI, NH, NC and SC for auto. In Michigan, the State Supreme Court found that insurer denial of coverage violated constitutionally protected due process rights. Michigan is the only state to require Full Insurance Availability for fire and homeowners insurance as well as auto insurance. Hawaii has a form of the FIA system in place for auto insurance as well.

shopping for insurance far less practiced than for most purchases.[7]

Selection competition is a very abusive practice, as Full Insurance Availability points out:

> The interface between these respective imperatives, as the applicant for insurance seeks the insurance which society has decreed he must have, and as the insurer seeks competitive success through selectivity, produces inevitable conflict and has left an ever-widening gap to be filled by residual . . . market mechanisms.

As former New York Superintendent Benjamin R. Schenck put it:

> Selection competition should have few admirers. It is capable of totally denying to some people the opportunity to buy insurance at all in a day when many forms of insurance have become legal and practical necessities.

If selection competition was eliminated, the supply and demand sides would become balanced and competition among insurers in price and service would be greatly enhanced. If this were coupled with good insurance information, consumers could shop and act upon what was best for them. They cannot today.

One of the Members of this Committee, Representative LaFalce of New York, has wisely asked GAO to review the costs to America of many of the other non-competitive activities insurers engage in under the McCarran-Ferguson Act's anti-trust exemption. These activities include:

- o Cartelized ratemaking;
- o Establishment of retail level (agent's) prices by the wholesale level (the companies). Insurance is one of the few parts of the economy still acting under the "Fair Trade" type anti-competitive situation;
- o Prohibition, under state law, of groups forming to purchase insurance at reduced rates (the "fictitious group" laws prohibit even employers from offering employees low-cost, true-group auto insurance, for example).

7. Particularly coupled with lack of disclosure of meaningful price information. The Full Insurance Availability Report prophecied that these FAIR plans would become "dumping grounds", viz: "While affording a handy dumping ground for

With all of these anti-competitive elements in place, it is no wonder that insurance premiums eat up 11.7% of the nation's disposable income, yet pay out less than 50¢ for each dollar of income. In his best-selling new book, The Invisible Bankers, Andrew Tobias finds that insurance is grossly inefficient, perhaps employing one million too many employees. As Tobias puts it:

> Roots of the industry's inefficiency are manifold. The fire insurance business grew up as a massive exercise in price fixing. The life insurance business is dominated by giant mutual insurers whose managements have no one to answer to but themselves. They are motivated toward growing larger, not leaner. One might expect the marketplace to impose its own economic discipline -- it is competition based on price that has always been the surest spur to efficiency -- but insurance prices, particularly life insurance prices, are notoriously hard to evaluate, leaving consumers unable to spot the best values and insurers under little pressure to provide them. Federal regulation and antitrust statutes largely exempt the insurance industry; state regulators are anxious to keep even inefficient companies profitable, lest policyholders be left stranded or claims go unpaid. Then, too, there are the problems of policyholders gleefully defrauding their insurers and of insurers callously chiseling their insureds -- an inherently inefficient and seemingly irremediable circle of distrust.
>
> There are ways to improve the system radically. But this is not an industry, by and large, that seeks radical improvement. Inbred and living in comfortable isolation with its state regulators, it has been slow to innovate. A "cash cow" of the first order, it has resisted change.[8]

7. (continued)
subjectively determined "bad" risks (the worst aspect of which may be their failure to fit the insurer's competitive mode), the plans likewise furnish an escape valve which has, thus far, preserved the traditional and hitherto sacrosanct perogative of the insurer to be arbitrary in the exercise of its underwriting judgments. There appears to be considerable basis for an inference that the plans have unintentionally provided a new vehicle for stepping up the abandonment of urban core areas by individual insurers."

8. Tobias, Andrew. The Invisible Bankers, New York: Linden Press, 1982, pp. 24 - 25.

Mr. Tobias' book should be required reading for every member of Congress.

The Urban Plans: Redlining Implications

Several years after the availability of these programs, HUD reported[9] that the Full Insurance Availability Report's prediction of the FAIR Plan's exacerbating redlining had come to pass:

> ". . . insurance redlining is widely practiced by insurers."
>
> Insurance companies redline by means of zip-code. As a result risks are rejected not on the basis of objective underwriting standards but rather on a highly subjective perception of risk assumed for general geographic location.
>
> Redlining has an undeniable racial component . . . correlation tests show that FAIR Plan policies are slightly more likely to be written in a black or Puerto Rican neighborhood than in a neighborhood that contains building violations.
>
> Insurance redlining today denies many urban property owners access to a voluntary insurance market. The practice is not based on any sound underwriting standards but rather on highly subjective criteria that would appear to result from unfounded generalizations or preconceptions about urban property risks. The effect of this practice is that many property owners are denied access to insurance at affordable prices. Consequently, what mortgage financing is available vecomes even more difficult to obtain. Economic life and opportunity for jobs are closed by this practice as business cannot expand without affordable insurance protection. Redlining relegates healthy risks to the residual insurance markets where they pay more for less coverage than their voluntary market counterparts. In short, redlining hastens the decline of neighborhoods and becomes a self-fulfilling prophecy. Any Federal, State, local and private efforts to maintain, let alone restore, our cities, will not succeed if insurance redlining is not arrested. The future of America's cities depends upon early resolution of this national problem.

This Report led to Congress passing the widely debated Holtzman Amendment, which tried to control the most blatant manifestation of redlining: high rates. It was

9. Insurance Crisis in Urban America, Federal Insurance Administration, 1978.

[illegible]

> [illegible]

> [illegible]

[illegible]

[illegible]

The Congress should amend Public Law 15, the McCarran-Ferguson Act, to require, as a standard for continued state regulation of the insurance business, that states enact Fair Insurance Availability programs so that "good" risks, regardless of location or other subjective characteristics could get insurance from the company of the customer's choice. "Good risks" for fire insurance would be defined in terms of previous experience, compliance with fire codes, lack of

arson history, etc. For crime insurance, the definition could include locks and other anti-crime devices.

The only way I can see for Congress to terminate these important programs is to create the climate where state systems will serve all of the legitimate insurance needs of America through the private, competitive market. As Full Insurance Availability pointed out:

> . . . the proposed reform . . . would . . . reverse the movement toward more Federal involvement . . . the Federal Crime Insurance Program could be completely withdrawn . . . FAIR Plans could also end, although Federal riot reinsurance could still be provided to insurers desiring it.

That is as true today as when it was written in 1974.

Further, this reform would enhance competition in price and service by eliminating selection competition for those risks qualifying under the "good risk" category. It is my belief that tens of billions of dollars will be saved if Congress would simply require insurers to deal for "good" risks as Congress defines that term, and if the National Insurance Consumer Organization, the states and others continue to develop needed consumer shopping guides to fill the current information void.

Conclusion

Please think, if you will, of today's economy, crying out for more productivity and lower out-of-pocket consumer cost; think of the insurance industry's gross inefficiency, eating up — like PAC-MAN — almost 12% of the nation's disposable income, yet paying back less than 50¢ for every dollar of income over the last

[illegible]

[illegible] Think of this [illegible] industry [illegible] application to any other financial [illegible]. Think of the anti-competitive behavior in which insurance companies engage. Think of the [illegible] in [illegible] made in the states in 1945 without standards for performance and without [illegible]. Think of the GAO's finding that "there are serious shortcomings in state laws and regulatory activities with respect to protecting the interests of insurance consumers in the United States." Think most of all of the [illegible] who are [illegible] and [illegible] into the [illegible] Plan, [illegible] and other residual markets, or even [illegible] at all where these plans do not exist.

If you think of these things, and I believe that you must, you will not simply [illegible] or simply extend these important [illegible] programs. Rather you should adopt the readily available alternative of making this industry more competitive, more efficient and more responsive to America's essential insurance needs through adoption of the simple standard that insurer's deal with insurable risks as a condition for continued state regulation of insurance under the McCarran-Ferguson Act.

[illegible]. Excluding life insurance, pension plans and other accumulation of cash value programs which are expected to hold large portions of premiums.

[illegible]. Issues and Needed Improvements in State Regulation of the Insurance Business, General Accounting Office, October, 1979.

[illegible]. Alternatively, this might be accomplished through creative repeal of the Anti-Trust Exemptions, an outcome encouraged by President Ford's Justice Department Commission on Anti-Trust Immunities in its report on The Pricing and Marketing of Insurance, January 1977; and by the National Commission for the Review of Antitrust Laws and Procedures, in its Report to the President and the Attorney General, January 1979.

Chairman GONZALEZ. Mr. Mersky, if you will please for the record give us your identification.

STATEMENT OF BARRY L. MERSKY, INSURANCE AGENT, GLOBAL INSURANCE CO., SILVER SPRING, MD.

Mr. MERSKY. Yes, Mr. Chairman, I am from Washington, and as the hour is late I too will try to summarize my prepared statement and ask that the entire prepared statement go into the record. Thank you for the opportunity to testify. My involvement with the Federal crime program, and I am going to discuss solely the Federal crime program, dates back to its inception in 1971, as the attached letter from James M. Rose, Jr., indicates.

For the last several years, as agents, we have been concentrating on commercial policies, as opposed to residential. Our clientele has been the "mom and pop" inner-city stores for which the program was originally designed. If you so desire, I could obtain written statements from these and perhaps other insureds. I only had 2 days to prepare this. If you like I will try to get written statements from the people that I am going to mention.

Chairman GONZALEZ. If it would not be an imposition and you could do so, I think it would add to the weight of the testimony. I appreciate the offer.

Mr. MERSKY. Be glad to, Mr. Chairman.

Point No. 1. Need to maintain FCIP—Crime does lead to business closings.

As you are aware, the Federal crime program was established following the urban riots of the 1960's to help keep businesses in the high crime—usually inner-city areas.

In some respects it has accomplished that goal, but it has not helped retain as many of the businesses as intended. Nevertheless, it is terribly important to realize that businesses, particularly small businesses, do close—often permanently—following repeated robberies or break-ins. For example:

One, Melvin Smith of Smitty's Bakery, located eight blocks from here along Pennsylvania Avenue SE., recently closed because his catering service suffered a severe loss from a break-in.

Two, Vivian Claypool of Pierre's Clothes on 14th and Park NW., closed last year following repeated break-ins.

Three, SIS Records, a few doors away, closed for the same reasons.

Four, Lynch's Liquor on L Street NW., near the Statler Hilton and White House, closed within the past 4 months because the proprietors, Mr. Byron and Mr. Schechter, were afraid of yet another holdup.

Whether or not a small business will permanently close following urban crime, it is manifest to any agent who works the streets that:

Point No. 2. Almost no other crime insurance is available. That is, without the Federal crime program, there would be no affordable crime insurance for the small businessman. I would like to take issue with several of the other people on the panel who have testi-1 that insurance is available. It may be available to the large

chain stores and to the large financial establishments, but for the small "mom and pop" stores it simply is not available.

For example, Kenner's Pharmacy, which is a small drugstore servicing a captive senior citizens clientele around 16th and R Streets NW., recently was denied break-in coverage by Aetna Insurance Co. The owner, Mel Sacks, absolutely needs the Federal crime insurance because he has been broken into several times, recently, and had his narcotics and other merchandise taken. If the Federal crime was not available, he does not know how he could remain in business, and if he closed, there is no place nearby where the senior citizens could get their prescriptions filled. What are these elderly people then supposed to do?

Two, Shepherd Market is a small Korean-owned convenience food store in upper Northwest Washington. There are no other food stores, large or small, within 10 blocks. Most other stores closed because of shoplifting and/or crime. The former owner, Mr. Kwan, told me repeatedly that given his losses, he also could not stay in business without the Federal crime program, but he stuck it out, made a living, and provided a genuine service for his neighborhood.

Three, Betty Wittenour, of Allen Business Machines, across from the National Portrait Gallery, around G Street NW., was the insured interviewed by NBC referred to by Mr. Rose in his letter of October 18, 1978. Mrs. Wittenour also had been canceled and unable to get standard break-in insurance. She was and still is very grateful for the existence of the Federal crime program.

Four, Leon's Clothing, in downtown Northwest had his insurance canceled by a large insurance company.

Five, Mr. Leroy Harper, an elderly, very small businessman, absolutely could not remain in his retail record store on 11th Street NW., a very high crime area, without Federal crime. He earns just a few thousand dollars a year from this business, but it is his living and it is respectable. If you take away this program, you would rapidly extinguish his livelihood. Then, given his age, neither he nor I know what he would do for an income.

Point No. 3. The Federal crime program is also very necessary to State lotteries. While the Members of Congress may be ambivalent toward State lotteries, their tax contribution is nevertheless significant in, I think, 20 States. The lotteries would have a difficult time protecting or collecting their money should this program not exist. For example:

One, House of Kleen, a drycleaners on Eastern Avenue and the District line, would not have been able to pay the Maryland State Lottery on several occasions following holdups.

Two, Mr. Tojo of Johnny Boy's Carry-Out in Oxon Hill, Md., would also be in severe debt to the Maryland Lottery and probably out of business following several crimes.

Cost problem. I know the Federal Government loses money on every crime policy written, but in my opinion, that is because the program has been structured to do precisely that. There are probably many lobbyists here today to urge that Uncle Sam get out of the insurance business, or at least not interfere with private industry. Their goal is to keep the Federal crime program from writing the good and profitable business, such as the large inner-city stores and supermarkets. As long as the FCIP operates with the attitu

of allowing private enterprise to get the cream, inherently, it will lose money. Thus, every few years, Congress is confronted with the renewal of this expensive Federal program, and it becomes increasingly difficult to justify the cost, in light of the budget deficits. The point is that this program loses money because private industry and the administration have structured, limited, and encumbered the program so that it must lose money. As long as the program is designed to underwrite those risks that private insurance companies do not want, it has to lose money, which I believe goes along with what Mr. Bernstein said about actuarially, it is impossible to write insurance for the small stores, which will always have large losses.

Then there are several what I call administrative-servicing company problems. By administrative-servicing company problems I mean such specifics as one, late payment rejection; two, slow claims payment; three, gross sales verification; four, inspection arrangements; and five, protective-device problems. I have briefly outlined each problem in my written statement.

In sum, Mr. Chairman, I would like to thank you again for this opportunity to testify regarding the Federal crime program. I think the program should be extended because there is no alternative insurance for the inner cities. Although it is not a perfect Federal program, it really does allow businesses to exist and improve the quality of urban life. The problems, which also are real, are overshadowed by the benefits.

[The prepared statement of Mr. Mersky and the statements referred to follow:]

GLOBAL INSURANCE

[illegible] BROOKVILLE ROAD
SILVER SPRING, MARYLAND [illegible]

[illegible]

STATEMENT ON HR [illegible]

by

BARRY L. [illegible]

April 1, 1982

95-255 O - 82 - 54

Thank you Mr. Chairman for the opportunity to testify on HR 5731.

My involvement with the Federal Crime Program dates back to its inception in 1971, as the attached letter from James M. Rose, Jr. indicates. Also, we have been quoted over the years by the Wall Street Journal (attached) and other news media (enclosed).

For the last several years, as agents, we have been concentrating on commercial policies, as opposed to residential. Our clientele has been the "Mom & Pop" inner city stores for which the program was originally designed. In the balance of my statement, I shall use specific names and incidents to point out the benefits and the problems of the Federal Crime Insurance Program (FCIP). Time permitting, I would have brought some of these storeowners with me, or at least their written statemente. If, however, my examples pique your interest, I am confident a meeting with them can be arranged.

Point I. Need to Maintain FCIP - Crime Does Lead to Business Closings.

As you are aware, the Federal Crime Program was established following the urban riots of the 1960's to help keep businesses in the high crime (usually inner city) areas.

In some respects it has accomplished that goal, butit has not helped retain as many of the businesses as intended. Nevertheless, it is terribly important to realize that BUSINESSES, PARTICULARLY SMALL BUSINESS, DO CLOSE —often PERMENATELY — FOLLOWING REPEATED ROBBERIES OR BREAK-INS. For example:

(1) Melvin Smith of Smitty's Bakery, located eight blocks from here along Penn. Ave. S.E., recently closed because his catering service suffered a severe loss from a break-in.

(2) Vivian Claypool of Pierre's Clothes on 14th & Park N.W. closed last year following repeated break-ins.

(3) SIS Records, a few doors away, closed for the same reasons.

(4) Lynch's Liquor on L St. N.W., near the Statler Hilton and White House, closed within the past four months because the propriators, Mr. Byron and Mr. Schecter were afraid of yet another hold-up.

Whether or not a small business will permanently close following urban crime, it is manifest to any agent who works the streets that:

Point II. Almost no other crime insurance is available. That is, without the Federal Crime Program, there would be no affordable crine insurance for the small businessman. None.

This unequivocal fact applies to virtually all types of businesses in Washington, D.C. but particularly for the inner city small retailer. For example:

(1) Kenner's Pharmacy, a small drug store serving a captive senior citizens clientele around 16th and R Sts., N.W., recently was denied break-in coverage by Aetna Insurance Co. The owner, Mel Sacks, absolutely needs the Federal Crime Insurance because he has been broken into several times, recently,and had his narcotics and other merchandise taken. If the Federal Crime was not available, he doesn't know how he could remain in business, and if he closed, there is no place nearby where the senior citizens could get their prescriptions filled. (What are these elderly people then supposed to do?)

I think that since many of his prescriptions are Medicare/Medicaid, without his nearby store, the government may end up paying more for the handling and shipping for the senior citizens' prescriptions he presently fills.

(2) Shepherd Market is a small Korean owned convenience food store in upper N.W. Washington. There are no other food stores, large or small, within ten blocks. Most other stores closed because of shoplifting and/ or crime. The former owner, Mr. Kwan, told me repeatedly that given his losses, he also could not stay in business without the Federal Crime Program.... but he stuck it out ...made a living....and provided a genuine service for his neighborhood.

(3) Betty Wittenour, of Allen Business Machines, across from the National Portrait Gallery, around G St. N.W., was the insured interviewed by N.B.C. referred to by Mr. Rose in his letter of 18 October, 1978 (see attached). Mrs. Wittenour also had been cancelled and unable to get standard break-in insurance. She was and still is very grateful for the existance of Federal Crime.

(4) Leon's Clothing in downtown N.W. had his insurance cancelled by a large insurance company. Mr. Adler told me more than once that he could not be in business without the Federal Crime Program because he could not afford the losses.

(5) Mr. Leroy Harper, an elderly, very small businessman, absolutely could not remain in his retail record store on 11th St. N.W., a very high crime area, without Federal Crime. He earns just a few thousand dollars a year from this business, but it is his living and it is respectable. If you take away this program, you'd rapidly extinguish his livlihood. Then, given his age, I'm sure he'd be totally dependent on Social Security or Welfare.

Point III. The Federal Crime Program is also very necessary to State Lotteries. While the members of Congress may be ambivalent towards State Lotteries, their tax contribution is nevertheless significant in, I think, 20 states. The Lotteries would have a difficult time protecting or collecting their money should this program not exist. For example:

(1) House of Kleen, a dry cleaners on Eastern Ave. and the District Line, would not have been able to pay the Maryland State Lottery on several occasions following hold-ups.

(2) Mr. Tojo of Johnny Boy's Carry-Out in Oxon Hill, Maryland, would also be in severe debt to the Maryland Lottery and probably out-of-business following several crimes.

I have a feeling that should you look closely at this matter, you will find that the Federal Crime Program is the most cost-effective way to insure these state tax revenues. But in any case, I believe the government has a moral obligation to protect those store-owners by providing Federal Crime Insurance.

I would like to use this January memo, to change my focus from why the NFIP should be continued, to what problems I have encountered over the years.

I. Lost Premium

I know the Federal Government loses money on every flood policy written, but in my opinion, that is because the program has been structured to do precisely that. There are probably many lobbyists here today to urge that "Uncle Sam" get out of the insurance business, or at least, not interfere with private industry. Their goal is to keep the Federal Flood Program from writing the good and profitable business, such as the large inner-city flood stores and supermarkets. As long as the NFIP operates with the attitude of allowing private enterprise to get the cream, inherently, it will lose money. Then, every few years, Congress is confronted with the renewal of this expensive Federal Program and it becomes increasingly difficult to justify the cost, in light of the budget deficits. The point is that this program loses money because private industry and the Administration have structured, limited and encumbered the program so that it must lose money. As long as the program is designed to underwrite those risks that private insurance companies do not want, it has to lose money.

II. Administrative-Servicing Company Problems

By "administrative-servicing company problems" I mean such specifics as (1) late payment rejection (2) slow claims payment (3) gross sales verification (4) inspection arrangements and (5) protective device problems. I have briefly outlined each problem in my written statement.

(1) "Late payment rejection" means that problems have arisen when renewal payments arrive one day past the due date. By present regulation, the insurance policy is cancelled and the payment refunded. There is, however, a significant time lag until the servicing company informs the agent that the policy has been cancelled and the late premium refunded. During this time, often 30 - 45 days, both the insured and agent believe the policy is active.

(2) "Slow claims payment" becomes a significant problem when you realize that most commercial policy-holders are small, often marginal, businesses. I have seen several go under during the time it takes to settle a claim.

(3) " Gross sales verification" becomes a problem when a store moves to a new location or experiences a sudden increase in business. One of our insureds is presently near litigation on such a problem which occurred on Wheeler Road S.E.

(4) "Inspection arrangements" is a problem when either the store owner has odd working hours, doesn't speak English well, or the inspection service is slow and lazy. Among our Spanish and Korean insureds, I am seeing an increasing number of rejections, simply because the inspector could not "arrange" an inspection.

(5) The protective device requirements, traditionally, has been the biggest source of problems. Fortunately, by making insurance contingent on the inspector's report, this problem has been somewhat alleviated. It nevertheless remains a problem because many structures, particularly old buildings, cannot or should not meet an absolute criteria.

In sum, Mr. Chairman, I would like to thank you again for this opportunity to testify regarding the Federal Crime Program. I think the Program should be extended because there is no alternative insurance for the inner cities. Although is is not a "perfect" Federal program, it really does allow businesses to exist and improve the quality of (urban) life. The problems, which also are real, are overshadowed by the benefits.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
FEDERAL INSURANCE ADMINISTRATION
WASHINGTON, D.C. 20410

18 OCT 1978

IN REPLY REFER TO:

Mr. Milton Mersky
Global Insurance
7219 Wisconsin Avenue
Chevy Chase, Maryland 20015

Dear Mr. Mersky:

I want to thank you for your constructive suggestions for improving the Federal Crime Insurance Program. As you know, some of our significant changes to the protective device procedures reflect comments from you and other insurance agents who have worked extensively for the Federal Crime Insurance Program since its inception in 1971.

You may also remember that the case of one of your insureds, whose business was saved by the existence of Federal Crime Insurance, was cited on an N.B.C. telecast describing Federal Crime Insurance.

Your efforts to promote Federal Crime Insurance in Washington, D. C. have been extremely helpful to the Program and a real service to residents and businesses who have thereby learned of the Program.

I hope you will continue to keep us informed of additional ways in which we can make the Program more effective.

Very truly yours,

James M. Rose, Jr.
Assistant Administrator for
Urban Property Insurance
Riot and Crime

KENNER'S PHARMACY
1701 — 16th STREET, N. W.
WASHINGTON, D. C. 20009
PHONE NO 7-2031 DU 7-3351

March 31, 1982

Gentlemen:

On January 24, 1982 I was burglarized by having windows busted in and forced entry. At that time I lost $1,500.00 in merchandise and $366.00 in damages. I called my agent Robert H. Kent Company the next morning and was informed they would turn it over to Aetna Insurance Co.. At the end of the week, I called my agent back to notify them "I never heard from Aetna."

That weekend on January 31, 1982 I was burglarized again. My loss was over $1,500.00 again. I called the Robert H. Kent Company (Agent) and was told this time I had to talk with Mr. William Eisenberg (heads the insurance Department) who was not available. He called me back the next day and informed me that I had no insurance for Burglary. The policy I had was attached with a bill from R. H. Kent Co, which stated it was for Burglary. In fact all my bills for many years stated burglary.

After many long talks with the R H. Kent Co., I called the Federal Crime Insurance and asked for coverage, which he wrote up.

Unfortunately I had 3 more burglaries in the following weekends before I could install 35 bars and stop the burglaries.

I feel their is a definite need for Federal Crime Insurance, as agents will or cannot supply this need for small business. If these burglaries would continue without insurance I would be forced out of business. I am the only Drugstore in this area serving Medicaid Patients and Senior Citizens.

Sincerely,

Melvin Sacks Pres.

Chairman GONZALEZ. Thank you very much, Mr. Mersky. You may have heard me refer to California, when we got to San Francisco in early January. It coincided with the devastating mudslide, floods, and all that was so tragic. It made nationwide headlines. Since then California legislators, mostly, have introduced bills that would provide flood insurance coverage for landslides, that result from heavy rainfall, and especially that type that you read about in the San Francisco area, especially north of San Francisco.

Do any of you gentlemen have any particular views on these bills that have been referred to this subcommittee.

Mr. BERNSTEIN. That is probably a question to a great extent of how much the Congress is willing to lose. It is how you allocate limited resources and whether you extend the flood program to yet another risk. There is some flood, mudslide, or mudflow which is covered by the flood program. Whether you include mudslide and then take on the whole question of land use and whether you can really develop southern California or northern California as well, and whether the program is prepared to succeed in taking on the politics of development when it has not proven it can take on the problems of flood-related development is probably subjective rather than a black-and-white question.

There is no question the program could cover anything it so defined, but you are talking about a multimillion-dollar additional exposure, and whether or not you can get the valid tradeoff of land use for that exposure is something that I personally doubt at this time.

Mr. HUNTER. One of the issues has always been the problem of how do you map these things, on the one hand. On the other hand, the problem of somebody pays in for 20 years and suddenly has a marginal landslide but not quite a mudslide, and how do you judge which is which. There are a lot of terrible claims situations. Perhaps the Administrator could help you on how you define when a mud flow starts and when a landslide starts. There has to be a definition, but it becomes very subjective, and you have to draw a line somewhere. So I would encourage you to look at that question carefully and consider if there are ways to either define it more clearly so that people buying it would be able to tell the difference or research the mapping issues so that the land use could be put into place to make it a program that over time would offer hope for disaster relief. There are issues cutting both ways on the subject.

Chairman GONZALEZ. Thank you very much.

Mr. Jones?

Mr. JONES. I think Mr. Hunter and Mr. Bernstein both make good points, and it would be an issue for the Federal Insurance Administrator to study and see what could be done.

Chairman GONZALEZ. There was one other question, and that is, as was pointed out, I believe by Mr. Bernstein, the present Administrator or the administration has increased the premiums tenfold, 2½ cents to 25 cents. Does that not make it competitive?

Mr. BERNSTEIN. It makes it noncompetitive in that while it is difficult as Mr. Shamberger pointed out to compare private reinsurance coverage with Federal since the coverage is somewhat different, the 25-cent rate is so clearly above what is needed to cover the exposure under all the standards that the Federal Insurance Ad-

ministration has used in the past and is using today to predict what its hazard is that no one is interested in paying that much more. In some cases it is included in the private package of insurance without a divisible premium.

The administration recognizes that the rate is not needed to cover riot losses and set the rate to cover the crime losses. To that extent it is unfair to say that the fact that insurers today are not buying riot insurance is evidence that it is not needed. It is evident that it is so overpriced that no one will pay for it. It may or may not be needed, but you have passed the level of discussion when priced at a level 10 times what it was before, when at the previous price it made $120 million worth of profit.

Chairman GONZALEZ. Mr. Mersky, did you have a comment on the rate in the premium now as an agent?

Mr. MERSKY. Well, I limit my scope to the Federal crime insurance program.

Chairman GONZALEZ. True enough, but there is such an interplay, since one of the reasons given for doing away with a crime reinsurance program is the fact that it is drawing away the profits from the other fund, and I just thought maybe you had some idea or some notion.

Mr. MERSKY. I do not have any notion of how the price, the actuarial pricing of that and so forth.

Chairman GONZALEZ. I want to thank you, though, because I think your presentation is very substantial.

Mr. MERSKY. If I may quickly add, there are several reasons why I feel that the program is not national in scope. One of the other panelists said the program is not national in scope, and I think there were two or three reasons for this. The first is that we are dealing with small businessmen, and when you are dealing with small businessmen you have to get the agents out to sell it to the small businessmen. Unfortunately, the Federal crime program was never set up to offer the agents sufficient commissions to justify selling it. Certainly our agency has managed to live with the commissions, but I think that many agents nationwide do not really care to sell the program because it is not really profitable to them. That is not to say their insureds may not be happy with a Federal crime policy. What happens is the insured, the store owner, may end up paying more money and/or not having any insurance at all, because the agents really do not want to go out and push the FCIP. And the second reason there are few policies sold is that many agents really do not even know that much about the Federal crime program. There has been virtually no publicity nationwide to them, and again, I think it is because of the ambivalent administration over the years by HUD or FEMA. I do not think one direction has ever been taken. It is always available, yet HUD or FEMA do not want to sell too many policies because they lose more money. They know that if they continue to lose money, Congress will cancel it sooner. So it muddles along. In sum, the problem is that the agents have spread the word amongst each other that there is too little money in it for them, yet in other places, agents are not even aware of the FCIP.

Chairman GONZALEZ. You answered a question I intended to ask. I had a request here from Mr. Lowery, who was here earlier, to be

allowed to submit some questions through the minority staff director, Mr. Tony Valanzano, and as far as I am concerned I have no objection since there is nobody else here to object, we will recognize Mr. Valanzano to direct some questions or perhaps make some questions.

Mr. VALANZANO. I would like to direct the first question to Mr. Bernstein. Since Mr. Hunter references the full insurance availability report, which I believe was done while you were Federal Insurance Administrator, I wonder if you had any comments concerning his comments on the report?

Mr. BERNSTEIN. Some Federal reports have more lasting value than others. I think that report and the recommendations I made in it have been proven wrong. That is all I can say. They seemed like a good idea at the time, but they have not worked out. In the States that did adopt it you found increases in the percentage of risks that have gone into the residual market, such as in Massachusetts, with 40 percent, North and South Carolina, incredible amounts. As to States like New York, without it, we have 10-percent residual markets. In theory it might have been a good idea, but has proved not to work for any number of reasons, which I am sure this is not the forum to go in to.

Mr. VALANZANO. Mr. Hunter, in your statement, one of the footnotes dealing with the flood insurance program, you refer to EDS winning the competitive bid and cutting NFIA costs about in half. This you say prompted Senator Proxmire to award then-Secretary Patricia Harris his rare Golden Taxpayer Savings Award. From Mr. Bragg the other day, we received information that the flood insurance contract for EDS for this year coming up will be in the range of $27 million a year. I believe when you were very much involved in the Federal takeover, that figure was $10 million in 1978–79. I was wondering whether or not you could tell us what your thoughts are about the validity of your original cost estimates and why you believe they have escalated so rapidly.

Mr. HUNTER. Well, the original cost estimates held for the first 2 years. The program was administered for about half the previous cost. There has been escalation in part because there has been growth in policies. Costs per policy is the only way to look at it. You will see that even at the higher levels currently being spent per policy that the cost is still somewhere if not half, maybe two-thirds, in that range, on a per-policy cost basis. You have growth. You cannot handle more policies for no money.

Mr. VALANZANO. FIA indicated that the growth in policies is nowhere the percentage in cost. Policies increased by about 33 percent since 1979, while costs have gone up 170 percent. One of the questions raised at the time of the takeover was that the cost of the contract may be in the $10- to $11-million range for the first 2 years, but what will happen after that. I believe Mr. Hunter and those who were at that time advocating this takeover indicated that these costs would not increase nearly as much as some of the members of the committee, particularly on this side, said it would.

Mr. HUNTER. I would be happy to submit for the record what FIA gave me in terms of the costs on a per-policy basis, and you will see that the program is being operated at less cost than fore. I would like to go on the record that Allstate, the Washingtor

article, both of those I would like to put in the record. I would be happy to submit that.

Chairman GONZALEZ. Without objection, it will so be submitted for the record.

[Mr. Hunter subsequently responded with a letter to Chairman Gonzalez, dated April 6, 1982, regarding flood insurance policy costs, with attached exhibits prepared by the Federal Insurance Administration. The Washington Post article, "Allstate Sets 24-Hour Rule on D.C. Renters' Policies," also follows:]

NATIONAL INSURANCE
CONSUMER ORGANIZATION

April 6, 1982

Representative Henry B. Gonzalez
Chairman
US House of Representatives
Subcommittee on Housing and
Community Development
Committee on Banking, Finance
and Urban Affairs
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Gonzalez:

In accordance with Mr. Valanzano's request at the April 1, 1982 hearing, I am pleased to attach exhibits prepared by the Federal Insurance Administration showing flood insurance program data from inception through 1981. The series of numbers pertaining to operating costs of NFIA v. EDS are:

NFIA:

	Servicing Cost (Actual Dollars)
1970	$55.43
1971	29.89
1972	24.31
1973	22.36
1974	27.15
1975	21.61
1976	30.19
1977	23.92
Total 1970-77	$25.59

EDS:

1978	$11.51
1979	10.96
1980	16.80
1981	16.99
Total 1978-81	$14.44
1983	$13.50 (estimated)*

* According to Mr. Valanzanio, the cost for EDS's services for FY1983 will be $27 million. Assuming 2 million policies will continue to be written, the per policy cost for 1983 will be $13.50.

344 Commerce Street
Alexandria Virginia 22314
(703) 549-8050

Thus, on an actual dollar basis, NFIA served the program at 177% of EDS's cost.

This is startling enough, but if we adjust this series for inflation (using GNP deflator) look at the numbers:

		1983 Dollars
NFIA:		
	1970	$135.76
	1971	69.71
	1972	54.20
	1973	51.91
	1974	54.07
	1975	54.70
	1976	51.13
	1977	37.94
	Total 1970-77	$ 48.72
EDS:		
	1978	$ 17.11
	1979	15.01
	1980	21.19
	1981	19.58
	Total 1978-81	$ 18.46
	1983	$ 13.50 (estimated)

Thus, on a constant dollar basis, NFIA's costs were 264% of EDS's costs. Quite a remarkable record, considering that the current contractor is doing at least as good a job in servicing the accounts as the previous entity and is certainly doing a better job in producing usable statistics.

In the event that you did not get it, I attach the April 1, 1982 Washington Post article regarding Allstate's 24-hour a day requirement. What is noteworthy about the article to me is the spectacle of the DC Insurance Commissioner begging Allstate to relent (and even suggesting two approaches that still are unfairly discriminatory, in my view) and Allstate's "magnanamous" agreement to "consider these options". This is an example of the weakness of states in protecting consumer rights and the need for an amendment to the McCarran-Ferguson Act as I suggested in my testimony.

Finally Mr. Bernstein argued that he was "wrong" when he authored Full Insurance Availability. Most of the others who worked on it don't agree with his opinion now, he was right. The reason he cited for concern more than 30% in the "residual market" in the three states he mentioned is wrong. There is zero percent in the "residual market" which is defined as a separate market charging separate rates. In the three states he mentioned, there is one integrated voluntary market serving the consumer's needs. The percentages he mentioned are those ceded to the reinsurance facilities. These facilities are behind the scenes and are created solely for the benefit of the insurers. The insured, even if ceded, has privity of contract with the company (State Farm, Aetna or whomever) that he or she deals with. If reinsurance is a "residual market" then in most states in most lines most policies are in the "residual market" of reinsurance. The fact is, the reinsurance market is not a "residual market".

In New York, the state Mr. Bernstein said had only 17% in the "residual market", Mr. Bernstein was correct. There insureds are thrown into a separate market with separate, high rates reserved for the insured. In this way, New York "protects" the people it requires to buy auto insurance. It is this approach that stifles competition and violates (according to the Michigan Supreme Court) due process rights of citizens.

Regarding the lack of competition in personal lines, I attach an analysis by the investment firm of Mabon, Nugent and Company. Note that the report concludes (at page 3) that "competition for personal lines has clearly ended . . . major insureds have decided . . . to raise rates by as much as 15 percent. Most insureds will remain with their current insurers due to fear of cancellation or lack of access to alternatives . . . . The result is neither conspiracy nor cartel but it might as well be."

Also, in discussing the major personal line of auto insurance (at page 26, the report says:

> What is remarkable is the ability of major companies to make rate increases stick despite a healthy ROE. Some reasons are (1) the distribution system has an inherent inefficiency that creates insurmountable problems (in the short term) for a new, price-cutting competitor; (2) the major companies (including the ISC companies) use a rating system grounded in underwriting profits rather than broader measures of profit; and, (3) low leverage industry-wide clouds the issue. On the other hand, combined ratios of 108 percent would have produced a net loss in the past (the location of some managements).

America needs full insurance availability. Congress should act!

I trust that this information is helpful. I would appreciate it if you would place this entire letter in the record of hearing.

It is always an honor to appear before the Subcommittee. I appreciate your gracious welcome and hospitality, Mr. Chairman.

Very truly yours,

J. Robert Hunter

J. Robert Hunter
President

JRH/m
enclosures

FEDERAL . . . AND
ADMINISTRATION

NATIONAL FLOOD INSURANCE PROGRAM
UNDERWRITING EXPERIENCE BY CALENDAR YEAR

March 1, 1982
Sheet 1

	1970(a)	1971	1972	1973	1974	1975
1) Average Amt of Ins. per policy	$ 15,900	$ 16,140	$ 16,140	$ 17,060	$ 21,950	$ 25,440
2) Earned Premium	1,491,964	4,361,097	6,518,664	12,694,833	23,298,863	34,964,535
3) Losses Incurred	291,640	1,837,136	8,243,408	43,203,802	22,346,922	89,746,936
4) Loss Adjuster Expense	35,128	222,087	974,616	4,421,148	2,490,870	7,216,899
5) Loss & Loss Adj. Ratio	.220	.474	1.416	3.752	1.066	2.773
6) Insurance Agent Commission	602,383	984,294	1,550,207	3,681,594	6,706,730	5,029,354
7) General Expense	1,040,040	1,541,404	2,232,754	4,566,760	8,133,125	8,959,089
8) Profit to Servicing Facility	74,598	217,565	325,533	634,742	1,164,943	1,748,427
9) Exposure - No. of Annual Terms	20,123	58,864	106,231	232,677	342,529	495,586
10) Average Premium	74.14	73.93	61.87	54.56	68.02	70.56
11) Operating Cost Other Than Agents Commissions & Loss Adjuster Expense	56.43	29.80	24.31	22.36	27.15	21.61
12) Insurance Agents' Commissions	29.94	16.72	14.73	15.82	19.58	10.15
13) Loss & Loss Adj. Cost per Policy	16.29	35.60	87.60	204.68	72.61	196.65
14) Operating Deficit per Policy	27.62	7.88	64.77	188.38	51.22	156.86

	1976	1977	1978	1979	1980	1981
1) Average Amt of Ins. per policy	$ 28,690	$ 38,100	$ 33,150	$ 37,650	$ 45,101	$ 50,[illegible]
2) Earned Premium	50,114,420	74,761,406	99,456,110	129,358,032	148,463,518	180,538,[illegible]
3) Losses Incurred	34,568,324	90,125,889	132,748,415	482,375,653	220,667,018	150,997,[illegible]
4) Loss Adjuster Expense	1,662,866	6,131,429	6,863,276	20,764,971	14,812,760	8,251,16[illegible]
5) Loss & Loss Adj. Ratio	.723	1.288	1.404	4.298	1.590	.88[illegible]
6) Insurance Agent Commission	10,936,889	15,326,946	21,243,638	26,932,833	28,524,861	39,661,83[illegible]
7) General Expense	18,093,863	20,094,514	13,924,450	16,536,232	29,599,361(b)	31,117,23[illegible]
8) Profit to Servicing Facility	2,506,721	3,738,070	1,017,633	1,390,706	2,596,091	1,767,8[illegible]
9) Exposure - No. of Annual Terms	682,386	996,553	1,298,383	1,635,580	1,916,153	1,935,860
10) Average Premium	73.44	75.02	76.60	79.09	77.48	93.2[illegible]
11) Operating Cost Other Than Agents Commissions & Loss Adjuster Expense	30.19	23.92	11.51	10.96	16.80(c)	16.99
12) Insurance Agents' Commissions	16.03	15.38	16.36	16.47	14.89(d)	20.49
13) Loss & Loss Adj. Cost per Policy	53.08	96.59	107.52	307.62	122.89	82.2[illegible]
14) Operating Deficit per Policy	25.86	60.87	58.79	295.96	77.10	26.[illegible]

(a) Calendar period from June 1969 to December 31, 1970.
(b) Includes $2,381,144 for development, printing and distribution of the new Flood Insurance Manual and the Business System to support its implementation.
(c) Operating cost is funded on an ongoing basis (starting in 1981) by the collection of an expense constant from each policyholder. This operating cost can be separated as follows:

	1980	1981
EBSFC Cost per policy - New Flood Insurance Manual and Business System, startup cost	$ 1.25	$ --
EBSFC cost per policy - Advanced supply of new insurance forms	.37	--
EBSFC cost per policy - All other costs including fee	12.40	14.87
NIF cost per policy	2.60	2.12
TOTAL	$16.80	$16.99

(d) A savings of $571,800 in commission was negotiated with the insurance agents of Puerto Rico by the FIA in connection with 57,126 policyholders who were required to purchase insurance as a condition of Federal disaster relief.

Source:

1970 - 1977 Financial and statistical reports of the National Flood Insurers Association
1978 - 1981 Financial and statistical reports prepared by EBS Federal Corporation (Servicing Facility)
1980 - 1981 Financial data prepared by FIA from FEMA contract records an expense incurred on the Map Information Facility Project (items 7, 8, and 11 include these expenses).

FEDERAL INSURANCE
ADMINISTRATION

March 1, 1982
Sheet 2

NATIONAL FLOOD INSURANCE PROGRAM
LOSS AND EXPENSE EXHIBIT

1969 - 1973 PART A VOLUNTARY PURCHASE
1974 - 1977 PART A MANDATORY PURCHASE REQUIREMENT
1978 - 1981 PART B MANDATORY PURCHASE REQUIREMENT

	1969 - 1973	1974 - 1977	1978 - 1981	1969 - 1981
		Financial Data		
Exposure - No. of Annual Terms	416,885	2,517,054	6,785,976	9,719,915
Earned Premium	$25,048,538	$183,143,214	$557,810,922	$766,002,674
Losses Incurred	53,575,994	236,787,191	986,788,674	1,277,151,859
Loss Adjuster Expense	5,654,789	17,492,064	50,682,175	73,829,028
Insurance Agent Commission	6,818,478	37,999,048	116,362,418	161,179,944
General Expense	9,381,867	55,279,781	91,176,279	155,837,927
Profit to Servicing Facility	1,252,427	9,157,161	6,772,314	17,181,902
		Analysis of Costs		
1) Average Premium	$60.09	$72.76	$82.20	$78.81
2) Average Loss & Loss Adjuster Cost Per Exposure Unit	142.08	101.02	152.88	138.99
3) Average Insurance Agent Commission	16.36	15.10	17.15	16.58
4) Operating Cost Other Than (2) & (3) Above (Servicing Facility Cost)	25.51	25.60	14.44	17.80
5) Operating Deficit	123.86	68.96	102.27	94.56
6) Loss Adjuster Expense As A Percentage Of Loss	11%	7%	5%	6%
7) Agent's Commission As A Percentage Of Premium	27%	21%	21%	21%

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Washington Post
April 1, 1982

Allstate Insurance to Consider Easing Rule for D.C. Renters

Two Allstate Insurance Co. executives agreed yesterday to consider relaxing the company's rule that new applicants for renters' insurance in the District of Columbia must have someone in their homes 24 hours a day.

The requirement was imposed last November, company officials said, because of high theft losses and low ceiling rates in the District.

James Montgomery, the D.C. insurance superintendent, met for two hours yesterday with the two Allstate executives, Frank R. Montgomery (no relation) and Gene E. Mulligan, who came from the company's headquarters in North Brook, Ill., to discuss the requirement. Superintendent Montgomery had requested the meeting after expressing concern that the rule might discriminate unfairly against renters who work or attend school and are gone from their homes during the day.

Existing Allstate policyholders in the District are not affected by the 24-hour requirement. It applies only to those seeking an Allstate renters' policy for the first time in the District of Columbia.

In adopting the rule, Allstate departed from the way it typically operates elsewhere and from the procedures of other major insurers such as State Farm, Geico and Aetna. The procedure normally is to offer insurance at regular rates to renters who have someone at home during the day and, in cases where they are not home, to issue the policy at a higher rate.

During the meeting, Superintendent Montgomery asked Allstate to consider introducing a policy with a larger theft-loss deduction—the threshold amount above which the company is responsible—and a lower premium. A second possibility, he said, would be for the company to accept other security measures, such as deadbolt locks or building security systems, in cases where the tenant's home was vacant during the daytime.

"They said they would give serious consideration to these options," Montgomery said. He said Allstate agreed to respond within 30 days.

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The Financial Stock Analyst

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February 26, 1982

**A LOOK AT PROJECTED
UNDERWRITING EXPERIENCE
OF THE PROPERTY-CASUALTY
INSURANCE INDUSTRY
ON A LINE-BY-LINE BASIS
FOR 1982 AND 1983**

PREVIEW - OPERATIONS

Nineteen eighty-one earnings rose 3 per cent to a new record -- $5.6 billion -- despite a $2 billion increase in underwriting losses. The industry* recorded its highest underwriting loss ever and second highest post-war combined ratio. Manual rates rose 7 per cent (including 8 and 10 point increases for homeowners and personal auto) and had a 5 point impact on written premiums. Discounting reduced total premiums by 5 1/2 per cent (and commercial premiums alone by 8 per cent). Increased insured values boosted total premiums by 6 1/2 per cent. About 2 points of growth was taken away by such factors as the spread of cash flow plans and audit premiums. As a result, written premiums grew only 3 1/2 per cent. Losses grew at half the rate of the preceding ten years -- only 6 per cent. Severity rose 11 per cent, frequency improved the result by 1/2 point, fewer catastrophes subtracted 1 point, the shift to cash flow plans subtracted 1/2 point, and under-reserving (at least compared to the prior year) subtracted 1 1/2 points. Operating expenses rose 10 per cent, but a slight reduction in commission rates (less profit sharing) held the overall expense increase to 6 per cent. Net new investable cash declined by $2 billion to $9.4 billion, its third consecutive decline. (Paid losses rose 10 per cent while incurred losses rose only 6 per cent which pared the loss reserve increase.) The after-tax yield rose 7 per cent as interest rates hit new highs. The return-on-equity remained above 17 per cent, a rather healthy level so far past the peak of the cycle. In the following pages we explain why we expect a fifth consecutive year of flat profits.

The theme of our preview of four years ago was that property-casualty earnings could remain flat for several years until returns got unsupportably low or until some external shock intervened. Two factors have combined to drive competition and produce flat earnings. The first is expense pressure: companies are neither willing to dismantle their infrastructure nor able to afford not using it, so they compete to maintain premium volume. The second is returns-on-equity: so long as returns are not dramatically inadequate companies compete. (Except that an individual company may conclude that its return, either experienced or perceived, is much lower than its competitors' and that, therefore, it ought not to compete.) Company executives do not like competition . The "invisible hand" gets short shift. Managements seem to argue that competition invariably puts the industry in jeopardy of ruin and the only responsible competitors are companies that do not take one's business. In short, although both commercial and personal lines seem quite competitive now, market inefficiencies may prevent the continuation of competition.

The big question is, "What happens to competition now?". Underwriting is mainly unprofitable, leading some to think competition has ended or will end soon. On the other hand, the bottom line is still good (albeit stagnant), leading others to expect further competition. Our answer varies by line.

* All figures and text throughout this report refer to Stock Property-Casualty Insurers, that is, companies owned by Stockholders rather than Policyholders.

TABLE I

STOCK COMPANY PROJECTIONS
($ amounts in 000,000)

The Underwriting Account

	E-1981	% Δ	P-1982	% Δ	P-1983	% Δ
Premiums Written	[illegible]	3.5	57600	7.6	[illegible]	12.1
Premiums Earned	[illegible]	4.1	[illegible]	6.5	[illegible]	10.3
Losses	43880	6.2	48650	10.3	54600	10.0
Loss Expense	6610	9.2	7350	11.2	[illegible]	11.6
Expenses	20220	6.3	21800	7.8	24100	10.6
Policy Dividends	850		800		700	
Statutory Und. Profit	(4500)		(7800)		(7300)	
GAAP Adjustments	310		400		700	
Adjusted Und. Profit	(4190)		[illegible]		[illegible]	
Loss Ratio	65.8		68.4		68.2	
Loss Exp. Ratio	9.7		10.1		10.2	
Expense Ratio	29.2		29.3		28.9	
Policy Dividends	1.2		1.1		0.9	
Combined Ratio	106.1		108.9		108.2	

The Investment Account

	E-1981	% Δ	P-1982	% Δ	P-1983	% Δ
Invested Assets @ Cost	119230	8.6	129800	8.9	142720	9.9
Avg. Invested Assets	114510	10.0	124520	8.7	136270	9.4
Pre-Tax Yield	8.70	10.7	8.83	1.5	8.81	(0.3)
After-Tax Yield	6.96	7.2	7.15	2.7	7.10	0.6
Invest. Inc. After-Tax	7970	10.0	[illegible]	11.7	[illegible]	10.0

Projected GAAP Earnings

	E-1981	% Δ	P-1982	% Δ	P-1983	% Δ
Adjusted Und. Profit	(4190)		[illegible]		[illegible]	
Investment Income	9900	21.7	11000	10.4	12000	9.1
F.I.T. (Credit) Und.	(1800)		(2700)		(2900)	
F.I.T. Inv. Inc.	1900		2100		2200	
GAAP Net Income	[illegible]	2.8	[illegible]	(10.4)	[illegible]	10.0

GAAP Equity

	E-1981	P-1982	P-1983
GAAP Equity @ Cost	35357	35000	37500
Avg. GAAP Equity	32467	34200	36250
ROE	17.2	14.6	15.3

Competition for personal lines has clearly ended (except for the long-term price difference between agency companies and direct writers). Rate increases are coming and in enough volume to turn the combined ratio down. Returns remain high and homeowners underwriting was turning without major rate increases so the size of recent rate increases is surprising. The major insurers have decided independently to raise rates by as much as 15 per cent. Most insureds will remain with their current insurers due to fear of cancellation or lack of access to alternatives. The small, low-priced insurer has scant opportunity to present his case. The rate system allows companies to focus on underwriting so that a losing combined is alone enough to call forth rate increases. Regulators are happy if they can avoid giving up (or the companies refrain from taking) the full underwriting profit allowed by law. No major company seems willing to stand toe-to-toe and fight for market share. The result is neither conspiracy nor cartel but it might as well be.

Competition for commercial property business is reported to have diminished. Companies reported at the end of 1980 that rates had stopped declining. They are reporting the same this year with even greater confidence. If this is true, then flat rates would produce an overall loss for these lines in 1982--rates on renewals must begin to rise soon to produce a breakeven bottom line and underwriting alone will surely remain in the red this year and next. Loss costs are well below historic growth rates and this gives some illusion of only modest premium inadequacy. When losses return to a more normal level, premiums will be clearly inadequate. Although there are differences of form among insurers, commercial property insurance policies are essentially fungible. Competition continues because underwriters are currently under instructions to retain "clean" renewals (the owners are honest and their business profitable). Before prices begin rising toward manual rates, these instructions must be changed. This in turn, requires an underwriting loss of sufficient size to impress management. And, of course, underwriting results are reported after the fact. So we have modest expectations for 1982.

Commercial casualty lines remain quite profitable. Although workers' comp. is the most obviously profitable line, general liability and commercial auto are also profitable. Malpractice is the only major unprofitable area and it affects but a few companies. Cash-flow plans and other service arrangements have eaten into premium floats and IBNR reserves. Competition has cut even further into premiums. Low premium growth seems to have caused companies that relate IBNR to earned premium to under-reserve. In addition, some companies are living on the fat reserves of 1979. Companies would prefer to ignore the full accrual of liability until premium volume is more robust. As we learned seven years ago, companies can be forced by internal or external pressure to adjust reserves at an unpropitious time. Commercial auto rates are rising as companies file to use ISO's 1980 rates. But there is no other sign of rate activity. Losses cannot be expected to grow as moderately as last year, so underwriting will deteriorate further. However, returns will remain high, hampering the implementation of higher rates. Commercial casualty is a year or more from an underwriting turn.

Premiums should pick up from last year's slow growth and personal-lines carriers will see more than commercial carriers. The effect of various factors on total premiums written is:

	1981E	1982P	1983P
Manual Rates	5.0%	7.5%	8.0%
Values	6.5	5.5	6.0
Discounts	(5.5)	(1.0)	2.0
Audit Prem., Etc.	(2.0)	(2.5)	(1.5)
Coverage	(0.0)	(1.0)	(2.5)
Total	3.5	7.6	12.1

Losses will grow somewhat faster than premiums this year although severity will ease. The effect of various factors on the growth of losses is:

	1981E	1982P	1983P
Severity	11.0%	6.0%	8.5%
Frequency	(0.5)	0.5	0.0
Catastrophes	(1.0)	1.0	0.0
Cash Flow Plans, etc.	(0.5)	(0.5)	(0.5)
Loss Reserves	(1.5)	1.0	1.0
	6.2	10.3	10.0

Slight shifts in other factors more than offset favorable developments in severity. Faster loss reserve growth can be justified on the basis of earned premium growth alone. Most of the slowing in severity results from reduced growth in property values and repair costs. Lumber and carpentry costs actually went down a bit at the end of 1981. Casualty severity should change very little. (Medical care costs, in particular, are quite resistant to deflationary pressures.) Because of this shift away from rapidly-paid property claims, incurred claims will rise 1/2 point faster than paid claims. Last year they rose 3 points slower. We note that a 10 per cent increase in losses is quite low by the standards of the 'seventies. We offer heavy odds that if wrong, then we will have underestimated, not overestimated, loss growth. Longer term, the industry is becoming more of a payments conduit. It will sell skill in claims handling and loss prevention backed up by stop-loss and catastrophe covers. Boutiques will survive for hard-to-handle risks but the broad range of companies will encounter difficulties similar to those faced by the 80 per cent of life companies who cannot write group health profitably.

The expense ratio continued to rise last year. Companies were eager to maintain current staff and add a normal number of trainees. An effect was that salary increases were two or three points below the general inflation rate. Now managements are beginning to flinch from high combined ratios, so expense controls will be more stringent this year, particularly affecting hiring. Commission rates will again decline slightly as few contingents will be owed. Expense pressure will begin to ease as volume growth picks up. During the 'eighties, expenses will be a key issue. Mr. "Hank" Greenberg has said his company must reduce its expense ratio by five points (to under 20 per cent) during the 'eighties; this goal may be too modest. Today more than 37 per cent of the industry's dollar outgo goes for expenses (including loss adjusting). At breakeven underwriting, this system of risk-sharing would return to customers only 63¢ of every dollar paid in. (The loss portion is even smaller for first-party claims.) Expenses have come down (albeit slowly) from 45 per cent of premiums in 1930.

Interest rates are starting the year in a favorable direction -- up -- for lenders with cash. Our estimates of 1982 investment income assume lower rates, on average, than in 1981. A smaller decline would, on balance, increase net income. (High real interest rates are favorable as the industry gives up less in premiums than it takes in added investment income.) We estimate a modest increase in cash flow (including a small upturn in the addition to loss reserves). Barring a sharp increase in loss payments, cash flow will be plus or minus 15 per cent from 1981 and most probably plus. Nineteen eighty-three cash flow will almost certainly rise. Our estimate of how net new cash will be used is:

	1981E	Avg. Rate	1982P	Avg. Rate	1983P	Avg. Rate
Short Treasuries	500	14.1	300	12.0	500	8.0
Long Treasuries	1000	12.9	600	12.0	1000	10.0
Short Corporates	415	19.5	1750	16.0	2250	10.0
Medium Term Corporates	415	15.5	1750	13.0	2250	11.0
Municipals	4600	11.2	4000	11.0	4000	9.5
Common Stocks	1000	5.1	500	5.1	1000	5.1
Preferred Stocks	700	12.2	700	12.2	700	12.2
Other Investments	800	16.3	1000	15.0	1200	13.0
Net Cash Flow	9430	12.0	10600	12.4	12900	10.0
After-tax Rate		9.7		9.2		7.4

Nineteen eighty-one bond rollover was nearly $20 billion (including short-term positions), which was on the books at an average yield of 11.3 per cent. Rollovers are the same amount in 1982 at an average yield of 13.5 per cent. Dividend increases help the yield. More preferreds would be bought if there was more supply of sinking-fund issues. Insurers have usually bought corporate bonds when underwriting losses rise but (a) large tax carry-backs, (b) caution, and (c) high tax-exempt yields will deflect this normal interest towards (a) municipals and (b) treasuries, perhaps even more than we have anticipated. The change in average assets times the change in yield equals the change in investment income. Last year a large change in yield fueled an unexpectedly large increase in investment income. Opinion on the course of interest rates varies at least as much now as it did a year ago.

Earnings are sensitive to a large number of factors. Some of these factors in 1982 are:

Approximate Impact Of	After-Tax $MM	% of Earnings
1% Change in Premium Growth	+/- 290	+/- 6
1% Change in Loss Growth	250	5
1% Change in Expense Growth	115	2 1/2
1% Change in Invested Assets	55	1
100 basis point Change in New Money Rate	110	2 1/2
1% Change in Consumer Prices	175	3 1/2
1 Point Change in Combined Ratio	425	8 1/2

The impact of each item on 1983 results would be the same (in percentage) if it occurred in that year. Factors with continuing effects (such as higher or lower invested assets) that start in 1982, would repeat their dollar impact in 1983.

The 10 per cent earnings decline we project will affect smaller companies more than large companies. We believe many large companies have anticipated the adverse loss and premium trends that are developing and have already taken some corrective action. We expect the earnings of major companies to fall in a range of plus or minus 5 per cent. (This applies to the dozen or so largest stock companies.) The rest of the industry should fall in a range of minus 5 per cent to minus 15 per cent (with a few adverse surprises). Personal lines companies will, in general, have the best premium and earnings comparisons. Commercial property companies will stage a come-back in premiums during the second half but will have the most disappointing earnings. Commercial casualty specialists face slow premium growth, but their earnings will vary greatly depending on how well they have matched loss reserves to actual liabilities.

[illegible]

	[illegible]			[illegible]			[illegible]			[illegible]		
	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			
[illegible]												
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]			
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We have estimated the invested assets and, thus, investment income for each category by estimating its share of loss reserves, unearned premiums, other liabilities, non-invested assets, and shareholders equity. Equity is calculated as a premiums-to-surplus ratio of 3-to-1 although stock companies actually average 2-to-1. It is GAAP equity--regulators look at statutory surplus, but GAAP is a more meaningful measure. If we were to base equity on its ratio to loss reserves, then returns on commercial casualty would decline and returns on commercial property would rise. "Additional" equity would decline.

Most large companies have some handle on returns by line although we believe they generally attribute less investment income to each line than do we. Major companies generally aim for an underwriting profit on new business (although first year business, in fact, almost always loses money). They will accept a projected loss on renewal business to keep it. (Between 75 and 85 per cent of the average company's business each year is renewals.) Newer, more aggressive companies are very aware of potential returns and compete for long-tail business. (Whether or not these companies are retaining enough income to pay eventual losses remains to be seen.) The vast majority of companies continue to measure their success by underwriting ratios but are forced to accept poor (to them) results by return-oriented competitors.

Surplus remains abundant and profits remain high. Still, personal lines underwriting should turn more profitable without an earnings shock. Underwriting losses in commercial lines will rise and it is not clear what force will be sufficient to turn them. We have cautioned for the past three years that little can happen to make results materially better than we project. Surprises are likely to be negative. We repeat this caution.

PREVIEW - STOCKS

Chart I shows stock property-casualty company GAAP profits (indexed to 1950) and the annual average of Standard & Poor's property-casualty stock price index (also indexed to 1950). Earnings have been considerably more volatile than stock prices. A better correlation is between stock price and book value but the ratio of price to book value has declined steadily since 1972. We believe this reflects: (1) a generally reduced valuation of equities and (2) the growing disparity between market value and carrying value of fixed income investments caused by generally rising interest rates. If a large portion of this disparity were realized for any reason (such as negative cash flow), book values would be severely damaged. (The argument for carrying fixed income assets at amortized cost is that they will be held until maturity. This is historically true.)

The trend of earnings has accelerated since 1970 as the least-squares growth lines show. Projected earnings are clustered around the eleven-year growth line and are not likely to decline to the longer-term trend.

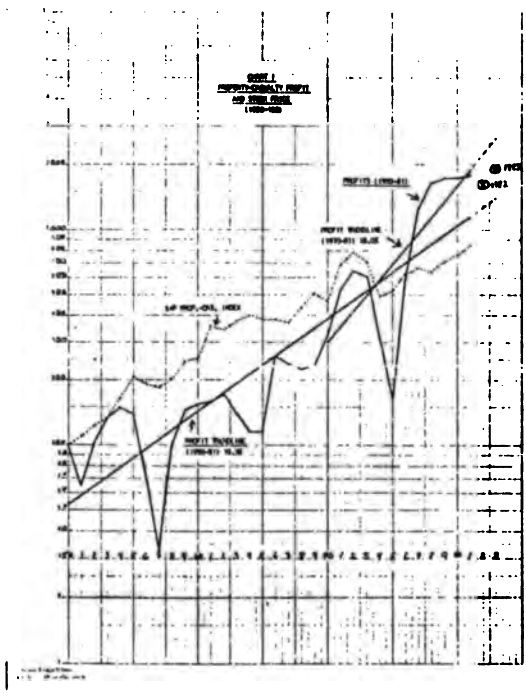
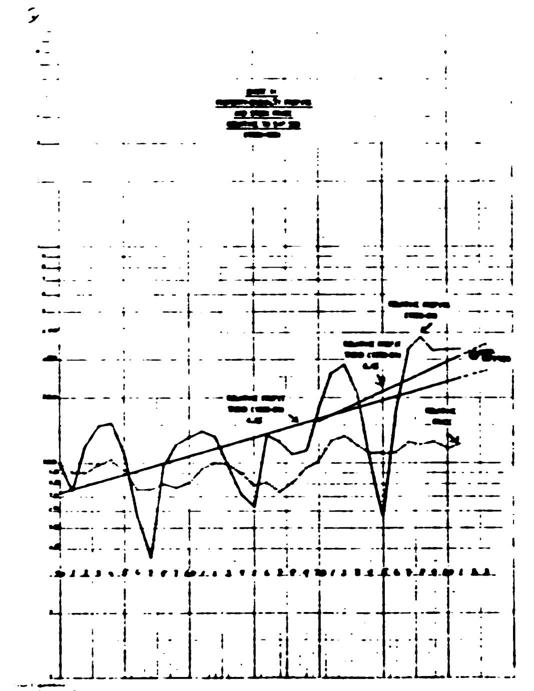
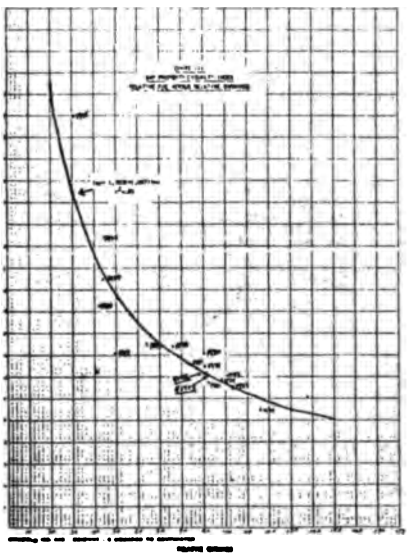
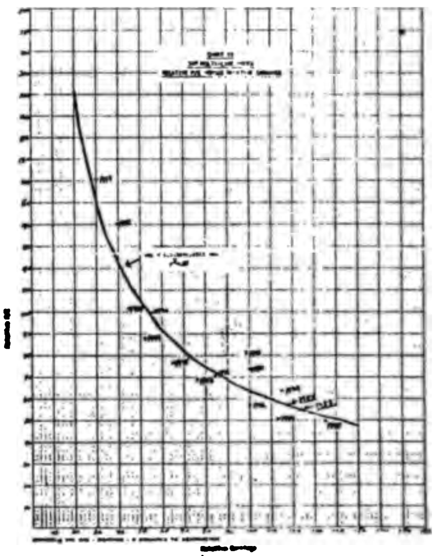


Chart II shows the data in Chart I divided by the earnings and prices of the Standard & Poor's 500 Index. The P-C industry has done relatively well in earnings growth with a least-squares compounded growth some 4 per cent faster since 1950 and 6.4 per cent faster since 1970. P-C stock prices have not done nearly as well, having outperformed by only 20 per cent cumulatively (0.5 per cent per annum) and all of that performance crowded into 1971. A basic revaluation of the industry began in 1968 but it was cut short by 1974-75 underwriting losses and by declining bond values. It is apparent that, low as the industry's valuation is, it has declined relative to stocks in general almost continuously during the past three decades in as much as relative earnings have grown 8 times as fast as relative price. (We assume the S&P P-C Index is a valid proxy for P-C stock prices in general.) <u>The group must be regarded as a candidate for revaluation up particularly if it survives this down cycle in underwriting with little damage to earnings</u>.



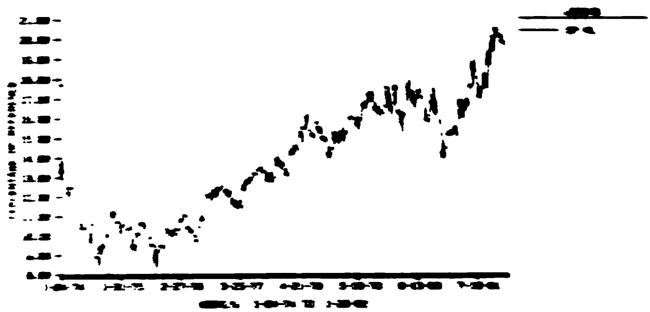
There is a strong correlation between relative earnings and relative price/earnings ratios for both the S&P Property-Casualty Index and the S&P Multi-Line Index versus the S&P 500 Index. (We use each year's average price.) The inverse relationship (in rough terms) is that for every 10 per cent the groups gain or lose in relative earnings, they lose or gain 5 per cent in relative P/E. Such a relationship is broadly typical of cyclical stocks although the correlation is rarely so good. For the P-C companies, 1980 and '81 were so close to the line it is impossible to say the relationship has been broken. However, the multi-line show distinct signs of breaking out of their track. They gained more relative P/E in 1980 and '81 than was predictable. We show, in Chart IV, the points the formula projects for 1982 and 1983. These points would result in 10 per cent underperformance of the S&P500. In fact, we expect the multi-line group to outperform the S&P500, that, in other words, it will hold on to much of its relative P/E gain. This would benefit P-C companies if investors sought investments in companies with similar characteristics. We recommend overweighted positions in multi-line companies as we believe they are likely to hold on to relative P/E gains. We recommend an average weighting in the property-casualty group because (a) there is earnings risk and (b) there is no evidence yet of a change in valuation. Both groups could appreciate relative to the market without becoming overpriced in historical terms.



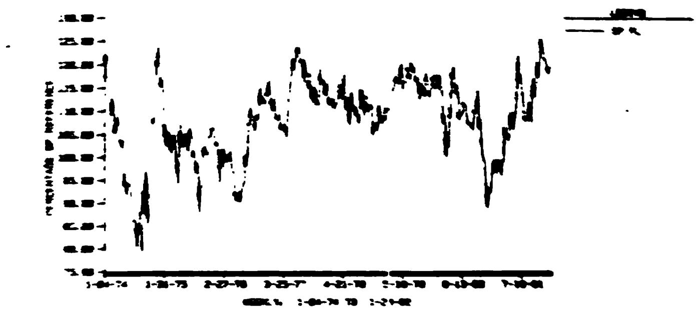


Charts I and II show the S&P Property-Casualty and Multi-Line Indices relative to the S&P500 weekly from 1974 through 1982. They serve to emphasize the point that the P-C stocks have stagnated in price (while gaining in earnings) and the point that the multi-lines have increased their price (although not to the extent of earnings). Also, note that the P-C stocks offer opportunities for significant relative gains over short periods of time even though their average relative price has remained stable.

MULTI-LINE INDEX
RELATIVE TO S&P 500



PROPERTY-CASUALTY INDEX
RELATIVE TO S&P 500



REVIEW - INFLATION

Table III shows least-squares, compound growth rates for various measures of the property-casualty industry (plus the average return-on-equity). These measures are all (excepting average stock price performance) higher for the most recent decade than for earlier periods. Much of this is, of course, attributable to inflation, which rose nearly four times as fast in the 'seventies as in the 'sixties. But all of the significant indicators (except stock price) show a substantial margin over inflation. In particular, note the 20 per cent growth in investment income and the 18 per cent growth in earnings -- the industry was, on balance, successful in translating increased investment income into earnings. In the last two columns note that a higher ROE is associated with increased volatility of returns.

TABLE III

STOCK COMPANY GROWTH

NOMINAL GROWTH RATES

(COMPOUNDED)

	CONSUMER PRICE INDEX	PREMIUMS WRITTEN	INVESTMENT INCOME	PREM. WRIT. + INV. INC.	LOSSES+ EXPENSES	GAAP EARNINGS	GAAP STOCKHOLDERS EQUITY	STOCKHOLDERS DIVIDENDS	S&P P/C INDEX	ROE	ROE STANDARD DEVIATION
1970-81	8.1%	11.8%	20.9%	12.9%	12.4%	18.0%	13.9%	13.3%	2.9%	16.0%	3.8
1960-70	2.6	7.9	8.7	7.9	7.9	7.6	2.3	5.7	5.8	9.2	2.7
1950-60	1.7	6.9	8.8	7.0	7.6	1.5	3.4	7.6	9.6	7.2	2.6
1950-81	3.7	8.6	11.5	8.8	8.9	10.3	6.4	9.0	6.7	11.1	3.7

Note: ROE = Average Annual Return On Equity

There is a canard making the rounds to the effect that disinflation (a remarkably ugly neologism) is good for property-casualty earnings. This has no basis in experience and is, in fact, diametrically opposed to the experience of the past thirty years. This erroneous view is formed from two basic misapprehensions. First, that property-casualty companies are not successful in passing on the effects of inflation. Second, that inflation after a loss occurs has a significant impact on the eventual loss peyment.

Table IV shows the growth rate of various measures of the industry after the underlying data has been adjusted with the consumer price index.

TABLE IV

STOCK COMPANY GROWTH

PREMIUM OVER RATE OF INFLATION

(COMPOUNDED)

	PREMIUMS WRITTEN	INVESTMENT INCOME	PREM. WRIT. + INV. INC.	LOSSES+ EXPENSES	GAAP EARNINGS	GAAP STOCKHOLDERS EQUITY	STOCKHOLDER DIVIDENDS	S&P P/C INDEX	ROE/ CPI	GNP
1970-81	3.5%	11.9%	4.1%	3.9%	9.1%	5.0%	4.9%	(5.1)%	7.5%	3.1%
1960-70	5.2	5.9	5.2	5.2	4.9	(0.3)	3.0	2.4	6.5	4.4
1950-60	5.1	7.0	5.2	5.8	(0.2)	1.7	5.8	10.5	4.8	2.9
1950-81	4.7	7.5	4.9	5.0	6.5	2.7	5.1	1.6	6.4	3.5

NOTE: Compound Growth Rate Of Items After Deflating By Consumer Price Index. Margin of ROE Over Inflation Rate.

Passing inflation on: The first column shows that written premium growth did slow in real terms during the 'seventies. Investment income growth nearly doubled. Total revenues grew 80 per cent as fast as in the 'sixties. On the other hand, measures of local inflation for P-C insurers have risen faster than general inflation. This might suggest that the industry was unable to deal with accelerating inflation. Part of the reduced growth of premiums is attributable to slower growth in constant dollar GNP--growth of insurable units slowed. Part is attributable to a very modest increase in the use of investment income in rate-making--the average combined ratio rose from 99.9 per cent to 100.6 per cent. Finally, part was due to a smaller increase in the net risk assumed by the industry--the aggregate dollar value of small losses retained by insureds has grown nearly as fast as the loss costs of higher insured limits. That is, dollars at risk in the U.S. have increased, but since 1970 an increasing portion of the increase has been funded through self-insurance, captives, deductibles, cash-flow insurance plans, and similar mechanisms. In our view, constant-dollar premium growth slowed largely because constant-dollar loss growth slowed. The objective proof is that earnings have grown nearly as fast as investment income, or, in other words, losses plus expenses have grown only slightly faster than premiums. Some observers have noted the declining real growth of premiums (actually negative during the past three years) but have failed to note the comparable decline in the real growth of costs. (The timing of the creation and discovery of loss reserve inadequacies does not materially affect the growth rate.) Given the evidence, one cannot plausibly argue that the industry would have been unable to pass along even more rapid loss growth. However, the market has reduced its valuation of these companies during the past decade despite their strong record of earnings growth. Reduced inflation might well be good for the stocks and bad for earnings.

Loss reserves: Inflation has a continuing effect on certain kinds of losses, such as those that require continuing medical care. It is also true that the longer a claim stays open the more it is likely to cost, but this reflects the contentious nature of large claims. Property claims are generally settled quickly for the value at the time of the loss. Casualty losses are often settled quite slowly with increasingly random results as the extent of injury rises. Cases with no loss payment can be among the most difficult to settle (the defense wins some four out of five jury verdicts). [illegible] do try to settle before a verdict when they believe the judge or jury will [illegible] the [illegible]. The range of payments for a particular injury is so wide as to render comparisons over time greatly misleading. Inflation does, of course, affect losses over time, but the greatest part of the effect is felt between the loss date of a recently paid, similar loss and the date of this loss (that is, before the loss date). Loss reserves for large companies contain an implicit provision for inflation as they are calculated from the past record of losses. So, a reduced rate of inflation should produce a favorable run-off [illegible] until inflation [illegible]. In addition, most annual premium rates are based on the past record of losses projected to the middle of the next year. A reduction in inflation will, then, produce a temporarily redundant rate.

A more interesting [illegible] is [illegible] of [illegible] and [illegible] leverage to [illegible] growth. Leverage is difficult to measure for an insurer. Premiums are an acceptable measure for property business as the premium is a percentage of the potential loss. By this measure, leverage has increased somewhat since

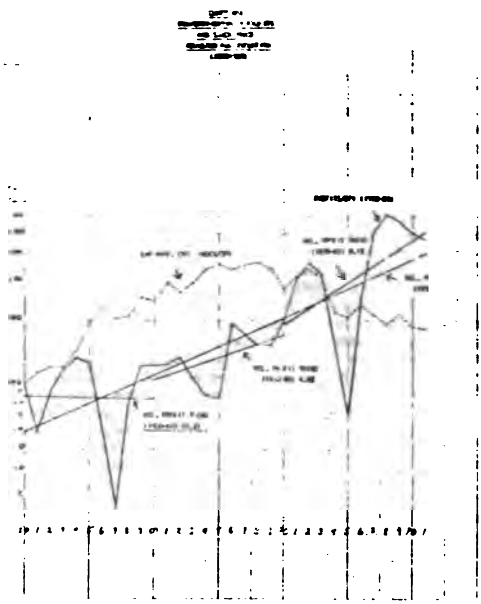
the 'sixties as can be seen in Table V. Loss reserves are one measure of the leverage of the casualty business (if the largest risk is underestimation of past losses). (They are also similar to debt.) By this measure, leverage has risen 50 per cent since the 'sixties and 150 per cent since the 'fifties. But larger loss reserves are in another sense a reduction of the risk of future deficiencies, so the measure is not perfect.

TABLE V
STOCK COMPANY GROWTH
MEASURES OF LEVERAGE
(AVERAGE FOR PERIOD)

				—— $ EFFECT ON EARNINGS OF A		——		COMB. RATIO
	PREM. WRIT. /EQUITY	LOSS RESERVES /EQUITY	1 POINT CHG. COMBINED RATIO	1% CHG. LOSS RESERVES	1% CHG. INV. INCOME	PROFIT MARGIN ON REVENUES	COMBINED RATIO	STANDARD DEVIATION
1970-81	2.5x	2.0x	12.1%	9.8%	1.0%	5.7%	100.6%	4.2
1960-70	2.2	1.3	14.7	8.5	0.9	3.8	99.9	1.3
1950-60	1.7	0.8	16.3	7.3	0.9	4.2	96.9	3.3
1950-81	2.1	1.4	14.4	8.7	0.9	4.3	99.2	3.6

Other signs of increased or decreased leverage are shown. The earnings impact of a one point change in the combined ratio has declined continuously while the impact of a one per cent change in loss reserves has risen modestly. Rising profit margins show that increased leverage is not the only reason for rapid earnings growth. While the average combined ratio has hardly changed since the 'sixties, its volatility has increased by a factor of three, indicating increased risk. The pattern is not clear, but increased leverage seems to account for less than one-half of real earnings growth.

Chart VII shows constant dollar profits and average stock price vividly. Profits have grown ever more rapidly while stock prices have fared more and more poorly. In other words, the stocks' valuation has declined as inflation has risen.



REVIEW - OPERATIONS

The following pages include information about the past ten years' operations for stock companies, five years of historical by-line results, and two years of by-line projections. These tables are either from A.M. Best & Co. Aggregates & Averages (1945 + ser.) or are derived in large part from it. GAAP results include our estimates. In so far as is possible, we have excluded income and equity from non-property-casualty sources because no comprehensive data is available. (This is most significant in the case of related life insurance companies.) Where appropriate we have also eliminated inter-company transactions. Our underwriting model is based on the results of nine major lines plus "all other". Our projections are based on past experience of the line and our assessment of the future for major factors such as: rate changes, discounts, units, coverage, values, loss frequency, loss severity, and reserving. Some of these factors can only be quantified indirectly for past years and anecdotal evidence is the main source for them. Tables XIII-XXV summarize past and projected results by line. Our investment income model is based on estimates of the earnings from each major category of investment, it provides for short and long-term investments, and it provides for rollover and net new investment. Some assumptions are unavoidable. For example, we assume that all capital gains are attributable to common stocks.

Last year, more than one-half of the underwriting loss came from general liability and private passenger auto ($1.0 billion and $1.5 billion respectively). Only fire and allied lines were profitable. The commercial lines had very slow premium growth as a result of competition, which is the major reason for the size of the general liability loss. The size of the private passenger auto loss was attributable primarily to a sharp reduction in the gain from lower frequency. Homeowners was the only major line to show improved results owing to reduced silver-theft losses, reduced catastrophe losses, fewer large losses, and sharply reduced inflation in home repair costs. Stock companies gained personal lines market share for a second consecutive year. Catastrophe losses for all P-C companies declined one-third to $700 million from $1.1 billion. Several sources note a decline of similar magnitude in the number and aggregate value of large fire losses for both commercial buildings and homes. Reduced loss frequency was spread widely through the lines. Worker's comp. benefitted from an absence of benefit increases as well as reduced loss frequency, particularly of major accidents. Malpractice was the only line with major reserve problems although a handful of companies added to workers' comp. reserves and a smaller number added to general liability reserves. Return-on-equity remained high. Cash flow declined for the fourth consecutive year while the yield shot up. Expenses remained a problem, especially loss adjustment costs--lawyers have not yet heard about reduced inflation. Forthwith our historical reviews and by-line analyses.

TABLE VI

P-L STOCK COMPANY EXPERIENCE
($ AMOUNTS IN 000,000)

UNDERWRITING RESULTS

Year	Prem. Writ.	% Δ	Prem. Earn	% Δ	Losses	% Δ	Loss Expense	% Δ	Expenses	% Δ	Pol. Div. & Other	Comb. Ratio
1981	60340	4	60180	4	45000	6	6610	9	20820	6	650	106.1
1980	60876	6	60022	8	42200	11	6082	10	18830	8	725	103.5
1979	63058	10	60748	10	38852	14	5492	13	17642	11	586	106.5
1978	57433	12	55455	14	33415	12	4800	11	15847	15	441	98.4
1977	51140	10	48720	10	29708	11	4385	18	13750	17	364	97.7
1976	45116	21	40853	19	26011	12	3725	10	11014	16	338	102.7
1975	35807	11	34085	10	24042	15	3130	12	10218	7	287	106.3
1974	32071	7	31382	8	20838	10	2793	14	9825	7	270	106.9
1973	30051	9	29086	18	17408	14	2442	8	8085	18	270	98.1
1972	27505	11	26926	12	15297	11	2257	9	8113	12	215	96.3
1971	24824	11	23780	11	13798	6	2090	9	7224	9	220	96.7

TABLE VII

	STATUTORY EARNINGS						STATUTORY POLICYHOLDERS SURPLUS			
Year	Und. Pft.	I.I.	Δ	F.I.T.	Earn.	%Δ	Stat. Earn.	Other Surplus Changes	Stat. Surplus	Prem. Writ./Surplus
1981	(4500)	10420	10	(200)	6150	3	6150	(4449)	42800	1.41
1980	(2674)	8856	16	218	5940	(3)	5944	2385	43400	1.41
1979	(994)	7001	35	586	6006	8	6006	566	39170	1.61
1978	885	5724	25	964	5863	29	5863	214	32500	1.77
1977	444	4847	28	575	4516	139	4516	(495)	28620	1.92
1976	(1800)	3820	15	40	1890	350	1890	2662	23512	1.91
1975	(3163)	3143	9	(456)	436	(82)	436	3187	18880	1.97
1974	(2844)	2891	16	(309)	1156	(40)	1156	(5376)	14430	2.22
1973	(30)	2491	20	226	2226	(1)	2226	(3575)	19670	1.53
1972	694	2040	16	502	2040	20	2040	1893	21080	1.31
1971	477	1700	24	402	1690	85	1690	1451	16820	1.47

TABLE VIII
ESTIMATED GAAP RESULTS

Year	Und. Pft.	Ppd.Exp.	I.I.	% Δ	F.I.T.	Adj. F.I.T.	Earn.	% Δ
1981	(4500)	310	9880	22	(200)	310	5380	3
1980	$(2674)	342	8804	18	218	208	5426	1
1979	(994)	497	6887	28	533	547	5350	4
1978	885	527	5899	24	964	715	5158	30
1977	444	405	4387	31	575	675	3957	112
1976	(1800)	338	3330	21	40	53	1866	285
1975	(3163)	131	2743	10	(456)	(342)	507	(50)
1974	(2844)	146	2491	20	(309)	(105)	1028	(40)
1973	(30)	232	2080	18	226	181	1028	(6)
1972	694	252	1760	15	502	393	1091	22
1971	477	165	1520	14	402	360	1626	65

TABLE VIII
ESTIMATED GAAP RESULTS

Year	Und. Pft.	Pyd.Exp.	I.I.	% Δ	F.I.T.	Def. F.I.T.	Earn.	% Δ
1981	(4200)	310	9960	22	(2800)	300	5580	3
1980	$(2674)	1342	8184	18	218	288	5426	1
1979	(974)	407	6907	28	538	547	5350	4
1978	883	927	5399	24	904	715	5150	30
1977	444	405	4357	31	575	675	3957	112
1976	(1699)	328	3330	21	40	55	1866	265
1975	(3165)	131	2743	10	(436)	(342)	507	(50)
1974	(2044)	146	2491	28	(309)	(165)	1005	(46)
1973	(38)	232	2030	18	228	181	1866	(6)
1972	674	232	1780	15	502	195	1991	22
1971	477	185	1528	14	402	180	1626	63

TABLE IX

	GAAP STOCKHOLDERS' EQUITY						RATIOS (AVERAGE EQUITY @ COST)				
Year	GAAP Earnings	Stockholders' Dividends	Unrealized Capital Gains	Δ Other Surplus	GAAP Equity	GAAP Equity @ Cost	ROE	Prem Writ./ Equity	Loss Reserve./ Equity	After-Tax Invest. Inc./ Prem.Writ.	After-Tax Invest. Inc./ Equity
1981	5580	2800	(1800)	(1800)	36283	33357	17.2%	2.1x	2.3x	11.9%	24.9%
1980	5426	2234	2889	937	35363	31577	18.4	2.1	2.2	10.1	22.9
1979	5350	1730	1053	(46)	29309	27188	20.8	2.3	2.2	8.9	21.9
1978	5150	1365	3	443	24721	23913	23.6	2.4	2.2	7.6	19.9
1977	3957	1067	(1059)	1774	20510	19705	20.0	2.6	2.2	6.8	18.9
1976	1866	814	1064	1185	16905	15041	13.4	2.8	2.3	6.2	19.1
1975	507	680	2307	581	12824	12824	4.0	2.8	2.3	6.3	17.7
1974	1005	748	(5316)	(953)	10229	12436	7.0	2.6	2.1	6.3	16.4
1973	1866	1240	(4323)	285	16341	15132	14.7	2.3	1.7	5.9	13.9
1972	1991	785	1640	945	19053	12221	17.0	2.5	1.6	5.0	13.6
1971	1626	730	584	1120	15851	10080	17.9	2.5	1.6	5.0	13.6

TABLE X
ASSETS, YIELD, AND INVESTMENT INCOME

Year	Invested Assets @ Cost	% Δ	Average Invested Assets	% Δ	Pre-Tax I.I.	% Δ	Pre-Tax Yield	% Δ	After-Tax I.I.	% Δ	After Tax Yield	% Δ	Eff. Tax Rate
1981	119830	9	114310	10	9960	22	8.70	11	7970	18	6.96	7	20.0
1980	109800	12	104140	12	8184	18	7.86	5	6728	20	6.48	7	17.8
1979	98499	14	92630	16	6907	28	7.46	10	5602	28	6.07	11	18.6
1978	86770	19	79815	21	5399	24	6.76	2	4347	28	5.45	3	19.5
1977	72880	24	65775	22	4357	31	6.62	0	3473	30	5.28	7	20.3
1976	58801	19	54055	15	3330	21	6.16	6	2667	17	4.93	4	19.9
1975	49415	10	47078	9	2743	10	5.83	1	2241	7	4.76	(2)	18.3
1974	44740	8	43085	11	2491	20	5.78	8	2080	17	4.85	8	16.9
1973	41431	13	38975	15	2030	18	5.34	3	1702	20	4.52	-4	18.3
1972	36580	17	33800	18	1780	15	5.28	(2)	1486	18	4.38	1	16.7
1971	31191	18	28795	NA	1528	14	5.31	NA	1230	13	4.28	NA	18.3

*Assumes Cost Equals 1975 Year-End Carrying Basis

NOTE: Assets and Investment Income After Elimination of Intercompany Items

TABLE XIII

Summary Table

BY - LINE MIX - PREMIUMS WRITTEN

	1977	1978*	1979	1980	1981	P1982	P1983
FIRE	4.9%	4.9%	4.1%	3.8%	3.8%	3.6%	3.4%
ALLIED	2.2	1.9	1.8	1.8	1.7	1.6	1.6
HMP	10.2	10.3	10.6	11.2	11.9	12.1	12.5
CMP	8.4	8.8	9.1	8.8	8.6	8.5	8.7
WORKER'S COMP.	13.5	14.5	15.5	16.0	16.4	15.4	14.7
GEN. LIAB.	11.4	10.9	10.0	9.3	8.7	8.5	8.4
P. P. AUTO	26.4	24.4	24.3	24.9	25.5	27.1	28.1
COMM. AUTO	9.0	9.0	9.1	8.8	8.6	8.7	8.7
IND. MAR.	2.7	2.8	2.8	2.9	3.1	3.1	3.2
OTHER	11.2	12.8	12.6	12.5	11.8	11.3	10.7
TOTAL ($MM)	51149	57433	63058	66875	69240	74500	83500

TABLE XIV

ADJUSTED UNDERWRITING PROFIT BY LINE

(IN MILLIONS)

	1977	1978*	1979	1980	1981	P1982	P1983
FIRE	$ 216	$ 255	$ 127	$ 5	$ 53	$ (75)	$ (30)
ALLIED	210	91	(46)	(43)	15	(110)	(75)
HMP	402	418	(19)	(405)	(289)	(140)	20
CMP	500	681	339	85	(321)	(590)	(490)
WORKER'S COMP.	(710)	(539)	(387)	(179)	(282)	(670)	(950)
GEN. LIAB.	19	97	25	(533)	(1000)	(1370)	(1550)
P. P. AUTO	94	28	(400)	(585)	(1454)	(1900)	(1750)
COMM. AUTO	146	142	(56)	(288)	(703)	(1110)	(1290)
IND. MAR.	179	200	77	(52)	(56)	(90)	(40)
OTHER	(206)	36	(137)	(527)	(153)	(525)	(645)
TOTAL	850	1410	(477)	(2331)	(4190)	(6600)	(6800)

TABLE XV

COMBINED RATIO (AFTER P.D.) BY LINE

	1977	1978*	1979	1980	1981	P1982	P1983
FIRE	90.4%	89.9%	95.4%	99.8%	99.4	103.0%	101.0%
ALLIED	80.2	92.3	103.5	103.7	99.2	109.1	105.4
HMP	91.3	92.1	99.6	105.2	103.4	101.2	99.8
CMP	87.1	95.0	95.6	98.9	105.6	109.4	108.4
WORKER'S COMP.	110.2	106.4	103.9	101.6	102.5	105.8	107.8
GEN. LIAB.	99.1	98.2	99.7	108.7	116.9	121.9	122.4
P. P. AUTO	98.9	100.2	102.4	102.2	108.4	109.4	107.4
COMM. AUTO	96.0	96.8	100.9	105.2	111.9	117.5	117.9
IND. MAR.	86.0	86.3	95.0	102.5	102.5	104.0	100.9
OTHER	102.7	100.0	101.3	106.4	101.7	106.0	106.7
TOTAL	97.7	97.4	100.5	103.5	106.1	108.9	108.2

*NOTE: In 1978, several large reinsurers changed to reporting all results as "Reinsurance." Their results are now included in "Other". Growth rates for premiums, losses, etc. have been adjusted to take account of this change in reporting.

[illegible]

FIRE

STOCK COMPANY EXPERIENCE

($ AMOUNTS IN 000,000)

	Prem. Writ.	% Δ	Prem. Earn.	% Δ	Losses	% Δ	Loss Exp.	% Δ	Exp.	% Δ	Pol. Div.	Und. Pft.	Δ Pol. Exp.	Adj. Und. Pft.	Comb. Ratio
1981	[illegible]	3	[illegible]	4	[illegible]	[illegible]	111	2	[illegible]	6	5	57	(4)	[illegible]	[illegible]
1980	[illegible]	(1)	[illegible]	(1)	[illegible]	4	[illegible]	12	[illegible]	2	4	2	5	5	[illegible]
1979	[illegible]	8	[illegible]	8	[illegible]	7	[illegible]	5	[illegible]	5	4	114	13	[illegible]	[illegible]
1978	[illegible]	6	[illegible]	7	[illegible]	3	[illegible]	9	[illegible]	[illegible]	3	[illegible]	5	[illegible]	[illegible]
1977	[illegible]	9	[illegible]	9	[illegible]	5	[illegible]	6	[illegible]	5	5	[illegible]	[illegible]	[illegible]	[illegible]

	1981	% Δ	1982	% Δ	1983	% Δ
Prem. Writ.	[illegible]	2.7	[illegible]	3	[illegible]	[illegible]
Prem. Earned	[illegible]	4.3	[illegible]	[illegible]	[illegible]	6
Losses	[illegible]	[illegible]	[illegible]	6	[illegible]	7
Loss Exp.	[illegible]	1.8	[illegible]	4	[illegible]	6
Expenses	[illegible]	2.7	[illegible]	5	[illegible]	[illegible]
Pol. Div.	5		5		5	
Und. Pft.	57		[illegible]		[illegible]	
Δ Pol. Exp.	(4)		[illegible]		[illegible]	
Adj. Und. Pft.	[illegible]		[illegible]		[illegible]	
Loss Ratio	[illegible]		[illegible]		[illegible]	
Loss Exp. Ratio	4.2		[illegible]		4.3	
Exp. Ratio	[illegible]		[illegible]		[illegible]	
Pol. Div.	.2		[illegible]		[illegible]	
Comb. Ratio	[illegible]		[illegible]		[illegible]	

Key Variables

Change in:	Rates	Values	Frequency
1983	[illegible]	[illegible]	2.0
1982	[illegible]	1.0	4.0
1981	[illegible]	[illegible]	[illegible]

Fire underwriting improved slightly in 1981 despite widespread price cutting and modest value increases. The main cause of this favorable result was a relatively low incidence of large fires. Some companies believe favorable loss experience was a result of their good underwriting but the low loss incidence was common throughout the industry. Arson was a less insistent issue than in 1980; perhaps managers felt claimsmen and fire marshals had become sufficiently alarmed. It is an industry truism that the incidence of arson correlates (inversely) well with economic activity -- a poor economy prompts arson-for-profit. One would have expected the combination of unprecedented interest rates and a poor economy to have wreaked havoc last year but it did not. By all accounts there is still plenty of reinsurance capacity to support low fire rates. However, some of the bigger reinsurance users report they are moving to stronger credits even with some price disadvantage. FAIR plan results continued to worsen and the year's worst fire was of FAIR plan properties in Massachusetts. The Reagan Administration will probably end the crime and riot reinsurance programs, which will push more business into FAIR plans.

The pure property lines require an underwriting profit of about three points to provide an attractive return. It is clear that rates are too low. Had losses reached a normal level last year, the line would have lost four points. The problem is not with manual rates, which seem adequate, but with credits on judgement-rated risks and with FAIR plan rates. With last year's good experience there will be little justification for raising rates, so a modest premium gain is to be expected. Losses will be aided by low inflation in building costs but hurt by more normal loss frequency. The result should be an underwriting loss, which will, in turn, produce rate increases sufficient to improve results in 1983.

TABLE [illegible]
ALLIED LINES
STOCK COMPANY EXPERIENCE
($ AMOUNTS IN 000,000)

	Prem. Wr'n.	% Δ	Prem. Ern.	% Δ	Losses	% Δ	Loss Exp.	% Δ	Exps.	% Δ	Pol. Div.	Und. Pft.	Δ Tpd. Inv.	Adj. Und. Pft.	Comb. Ratio
1981	1170	(2)	1200	1	680	(7)	71	(7)	425	2	4	20	(9)	15	99.2
1980	1193	3	1185	2	730	(11)	76	15	418	6	3	(42)	3	(45)	101.7
1979	1161	4	1163	3	820	20	80	10	396	2	3	(40)	60	(40)	103.5
*1978	1118	2	1120	5	687	20	80	16	380	9	2	97	8	90	91.3
1977	1120	11	1092	11	680	(11)	58	15	354	0	3	200	9	210	88.2

	E-1981	% Δ	1982P	% Δ	1983P	% Δ
Prem. Wr'n.	1170	(1.8)	1270	4	1370	10
Prem. Earned	1200	1.2	1260	5	1370	9
Losses	680	(7.3)	780	25	880	3
Loss Exp.	71	(6.6)	80	13	88	8
Expenses	425	1.7	430	6	460	9
Pol. Div.	4		3		3	
Und. Pft.	20		13		(30)	
Inv. Inc. Tax	13		3		19	
Adj. Und. Pft.	15		(10)		(17)	
Loss Ratio	56.7		60.9		65.0	
Loss Exp. Ratio	5.9		6.7		6.2	
Exp. Ratio	35.5		37.0		35.0	
Pol. Div.	0.3		0.4		0.4	
Comb. Ratio	99.2		105.1		106.6	

Key Variables

Change in:	Rates	Values	Catastrophe Losses
1981	5.0	9.0	9.0
1982	5.0	1.0	10.5
1983	3.2	6.7	(3.8)

Allied lines returned to the black after two years in the red. The improvement was the result of improved loss experience, in particular a sharp drop in catastrophe losses. Saturn did not cause severe losses as some had expected. Catastrophe losses for all lines totaled $700 million, down from $1.1 billion in 1980. The reduction for stock-company allied-lines was about $75 million. Even with this help, the line earned a bare $15 million. Like other lines, allied lines suffered a third straight year of modest premium gains. In commercial casualty this could be laid to increasing use of non-insurance solutions to risk management but alternative funding (excepting deductibles) is not in vogue in property lines. Nor can outside pressure to hold down rates be blamed -- manual rate increases are easily obtained. Competition knocked eight points off premium growth last year. In 1979 and 1980, experience justified rate cuts. Last year, only good fortune in losses supported them. The federal government has returned crop insurance completely to private insurers. This will add some volume. The administration has discussed abandoning flood insurance, but the program has a large constituency.

We are projecting a more normal catastrophe experience in 1982, which will cause a significant increase in losses. Manual rates should rise this year because a 99 per cent combined ratio is not good enough in a favorable loss year. Five points of profit should be earned in an average year and more in good years. Rates actually are lower than a year ago although the decline appears to have stopped. The rates paid will again average lower than last year and values should rise more slowly than in recent years, and the net result will be a sharp rise in the combined ratio. By 1983, premiums should be rising rapidly. If losses grow at a more normal rate, then results will improve. Volume (and losses) are still affected by the shift of monoline business to package forms.

[illegible]

Homeowners results improved during 1981. Due to 1980's underwriting loss, companies were not eager to increase the level of competition. As a result, premium growth was stronger than for any other major line. This owed little to rate increases (which will be felt in 1982) and a great deal to insurance-to-value. Apparently, a poor economy did not diminish the propensity to increase insurance coverage. Customers showed no major reaction to the conversion of remaining broad-coverage policies to limits on silver, jewelry, and so forth, a step that certainly cut losses. Declining silver prices cut losses even more. Catastrophe losses declined more than $30 million. Fewer high-value fire losses occurred than in 1980. Premium growth helped results, but the real cause of an improved result was the small increase in losses. The line would have lost another $400 million had losses grown at an average pace. Towards year-end the cost of items associated with home repair declined. This gives some hope of milder loss experience in 1982. After the inclusion of investment income, the line returned a profit on revenues of about 4 percent, which is a below-average ROE (about 12 per cent). Underwriters will seek to improve on this result.

The industry consensus favors rate increases, so we will see more in 1982. Unit growth may even rise. Values should increase more slowly than in recent years, which will affect both premiums and losses. Our target for losses is based on past experience of an erratic but visible six-year cycle in losses. The direction is towards improved results. But losses increase at an average rate (about 15 per cent), then experience will deteriorate by several points. Loss trends should worsen in 1983, but strong premium growth will offset them. Catastrophe losses will be the big swing item in both years.

TABLE [illegible]
COMMERCIAL MULTIPLE PERIL
STOCK COMPANY EXPERIENCE
($ AMOUNTS IN 000,000)

	Prem. Writ.	% Δ	Prem. Earn.	% Δ	Losses	% Δ	Loss Exp.	% Δ	Exp.	% Δ	Pol. Div.	Und. Pft.	[illegible]	[illegible]	Comb. Ratio
1981	5035	1	[illegible]	8	3367	9	[illegible]	10	2706	4	[illegible]	(579)	[illegible]	[illegible]	[illegible]
1980	5007	2	5700	6	[illegible]	[illegible]	523	23	2114	8	30	[illegible]	95	[illegible]	[illegible]
1979	5161	15	[illegible]	16	2801	30	[illegible]	30	1962	17	[illegible]	265	[illegible]	[illegible]	[illegible]
1978	[illegible]	10	4775	19	[illegible]	13	[illegible]	7	1675	21	30	[illegible]	[illegible]	[illegible]	[illegible]
1977	4321	23	[illegible]	23	1871	8	[illegible]	[illegible]	[illegible]	27	4	435	[illegible]	[illegible]	[illegible]

	[illegible]	% Δ	[illegible]	% Δ	[illegible]	% Δ
Prem. Writ.	[illegible]	[illegible]	[illegible]	7	[illegible]	15
Prem. Earned	[illegible]	[illegible]	[illegible]	6	[illegible]	[illegible]
Losses	[illegible]	[illegible]	[illegible]	11	[illegible]	11
Loss Exp.	[illegible]	9.9	[illegible]	[illegible]	[illegible]	11
Expenses	[illegible]	[illegible]	[illegible]	7	[illegible]	[illegible]
Pol. Div.	[illegible]		[illegible]		[illegible]	
Und. Pft.	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
Adj. Und. Pft.	[illegible]		[illegible]		[illegible]	
Loss Ratio	[illegible]		[illegible]		[illegible]	
Loss Exp. Ratio	9.9		[illegible]		[illegible]	
Exp. Ratio	[illegible]		[illegible]		[illegible]	
Pol. Div.	[illegible]		[illegible]		[illegible]	
Comb. Ratio	[illegible]		[illegible]		[illegible]	

[illegible]

Change in:	Rates	[illegible]	Values	Frequency
1983	[illegible]	[illegible]	[illegible]	[illegible]
1982	[illegible]	[illegible]	7.0	[illegible]
1981	[illegible]	[illegible]	[illegible]	[illegible]

One year ago we reported the opinion of "some company executives" that rates had, at least, stopped declining. Our sources were wrong. They are singing the same refrain again this year. We again believe them but with diminished faith. The commercial mul'iple-peril combined ratio has deteriorated by twenty points in three years despite unaccustomedly slow loss growth. Price cutting is the reason for this reversal of fortune. Manual rates and insured values each continued to rise -- by a combined 11 per cent in 1980 and 14 per cent last year. The average rate cut was, then, 9 per cent in 1980 and 13 per cent last year. That is to say, the average commercial insured paid, in 1981, less than 80 per cent of the 1979 rate per dollar of coverage. Quarterly data indicate that competition was most severe in the first half of 1981 and that it eased slightly in the second half--discounts dropped from roughly 17 per cent to only 11 per cent. In 1979, this line's ROE was 29 per cent. It fell to 5 per cent last year. A return this low should be sufficient to cause price increases. Arguing against them is the general paucity of volume combined with the known desire of companies to keep CMP renewals. Companies promise a "competitive" price if the agent does not seek competing quotes. But if no one is competing, this process may lead to companies competing with themselves.

Another year of flat premiums is unlikely but showing the full effect of increases in rates, values, and coverage is only slightly more likely. There is every reason to believe losses will reflect a full measure of increased values and coverages. Catastrophes and large fires have been fewer the last two years and this favorable loss experience has supported an unprecedented degree of competition. Rates cannot be changed overnight. As a consequence, results are likely to worsen this year and to produce an overall loss. By next year, premiums will have enough momentum to produce earnings.

Workers' compensation earned the industry more than $[illegible] billion and over one-quarter of total stock company profits. This is a [illegible] per cent [illegible] (the [illegible] [illegible] [illegible]-to-[illegible] premium-to-surplus). The industry earned a four point underwriting profit before policyholders' dividends, about the same as in [illegible]. There is a wide more than [illegible] points' disparity among the combined ratios of various companies. This results in large parts from different perceptions of loss reserve needs. The heavy reservers are probably right and so we expect some adverse results from other companies when they discover the problem. The magnitude of the difference is roughly $[illegible] million. Premium growth slowed due to retrospective adjustments, rate credits, audit adjustments, and the continued shift to cash-flow and self-insured plans. These factors combined to reduce written premium growth by ten points. Losses also grew more slowly than usual because: (a) benefit increases have been small recently and prior increases have worked their way through the system, (b) cash-flow plans do not require a reserve until a loss is reported (or [illegible] accounting of a year made), (c) loss frequency has declined somewhat, (d) [illegible] indications were affected by low earned premium growth, and (e) case reserves were, we believe, understated by some companies.

Premium growth will be adversely impacted in [illegible] by rate reductions, recession-related unemployment, slower growth in paychecks, and audit credits. Although benefits will show virtually no increase, losses should rise a little faster than in [illegible]: as frequency climbs, as more companies discover reserve problems, and as medical care costs show every sign of resuming inflation. One-half of the states use investment income explicitly or implicitly in setting rates. For this reason, we expect rates to decline again in [illegible] despite a modest increase in benefits. Losses will slow a bit because reduced frequency and reduced reserve strengthening will offset benefit and payroll increases. Competition is pushing the combined ratio towards 1[illegible] per cent before dividends.

[illegible]

	[illegible]	% Δ	[illegible]	% Δ	[illegible]	% Δ	Loss Exp.	% Δ	Exp.	% Δ	Pol. Div.	[illegible]	[illegible]	Adj. [illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

	[illegible]	% Δ	[illegible]	% Δ	[illegible]	% Δ
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Losses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Loss Exp.	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Expenses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Pol. Div.	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
Loss Ratio	[illegible]		[illegible]		[illegible]	
Loss Exp. Ratio	72.8		71.4		[illegible]	
Exp. Ratio	[illegible]		[illegible]		[illegible]	
Pol. Div.	[illegible]		[illegible]		[illegible]	
Comb. Ratio	[illegible]		[illegible]		[illegible]	

[illegible]

[illegible]	[illegible]	[illegible]	[illegible]	Rates	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

[illegible]

	[illegible]	% Δ	[illegible]	% Δ	Losses	% Δ	Loss Exp.	% Δ	Exp.	% Δ	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Medical malpractice produced one-third of the line's underwriting loss. Excluding that, GL had a combined ratio of 112.8 per cent, it earned $700 million, and it showed a return-on-equity of 40 per cent. (This assumes a premium/surplus ratio of three-to-one and the ability to use the tax-loss created by underwriting.) Malpractice alone did lose a few dollars.

Malpractice is well on its way to giving the industry a black eye again. The high level of losses combined with no reasonable expectation of sufficient rate increases will again cause an availability crisis. And the doctor-owned companies are only a year or two away from seeing the same results as stock companies or worse. No conceivable shift in the judicial winds can eliminate enough losses to make the line whole. Perhaps the answer for the doctor-owned companies is to shift to true cash-flow underwriting: i.e., reserve only for paid claims. This would hide the problem for another seven years. Stock company experience is bound to worsen as old losses emerge while premiums decline. The line is not large enough to sink a major stock company.

General-liability underwriting deteriorated by six points. This is the fruit of several years of rate cutting. Last year's rate cuts were smaller than in 1980. This year, audits will produce return premiums. We do expect sizable manual rate increases. Losses were quite mild in 1981, and 1982 will benefit from similar factors: that per severity (at least as perceived) is growing more slowly, and that IBNR growth has slowed owing to declining premiums. These factors will not be strong enough to prevent the combined ratio from reaching 118 per cent. There is every reason to expect a further cyclical increase in losses to raise the combined ratio again in 1983.

PPA threw off $1.1 billion in profits for stock companies last year -- equal to a 20 per cent ROE for a company writing three-to-one. Not long ago it appeared likely PPA would decline as a percentage of stock company premiums. Instead, several stock companies now expect it to be a major growth area. The line has benefitted from greater regulatory awareness of inflation and greater rate freedom. Also, companies suffer less if they post rate increases before their competitors than was true seven years ago. Rates rose 11 per cent last year and were rising at a 15 per cent annual clip at year end -- about as fast as losses were rising. Premium growth was hurt by declining coverage: new car sales were down, the fleet aged, and people dropped coverage. On the loss side, inflation added 12.5 per cent to costs, but total severity advanced 17.5 per cent including such effects as the greater cost of repairing small cars. So in the end there was a large, unfavorable disparity between growth in premiums and growth in losses.

Last year's sharp run-up in losses caused the industry to accelerate plans for rate increases. What is remarkable is the ability of major companies to make rate increases stick despite a healthy ROE. Some reasons are (1) the distribution system has an inherent inefficiency that creates insurmountable problems (in the short term) for a new, price-cutting competitor; (2) the major companies (including the ISO companies) use a rating system grounded in underwriting profits rather than broader measures of profit; and, (3) Low leverage industry-wide clouds the issue. On the other hand, combined ratios of 108 per cent would have produced a net loss in the past (the location of some managements).

If the factors that made severity four points worse than inflation last year are long-term trends (and we believe they are), then the industry will require 15 per cent rate increases to turn underwriting. (Frequency should improve only modestly.) Some of the largest auto insurers are ahead of the market in raising rates and should experience improved results during the next two quarters. Improvement will be delayed until early 1983 for most companies.

[illegible]

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

	[illegible]	%	[illegible]	%	[illegible]	%
[illegible]	[illegible]	1.5	[illegible]	8	[illegible]	13
[illegible]	[illegible]	5.5	[illegible]	4	[illegible]	11
[illegible]	[illegible]	[illegible]	[illegible]	11	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	1	[illegible]	[illegible]
[illegible]	[illegible]	4.0	[illegible]	6	[illegible]	[illegible]
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	10.7		[illegible]		11.7	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	[illegible]		[illegible]		[illegible]	
[illegible]	111.9		[illegible]		[illegible]	

[illegible]

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	11.5
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

The commercial auto combined ratio rose to 112 per cent last year, but the line still earned about $300 million (equal to a 15 per cent ROE). Manual rates are not the cause of slow premium growth -- the industry got an average increase of 15 per cent in 1980 and 16 per cent in 1981. An ISO member can choose not to implement a rate increase and most companies did not begin implementing these increases until late last year. Non-implementation was, in effect, a discount each year of 12 per cent. Delays in implementation and the fact that prices are now below last year's average will amount to a further 8 per cent effective rate cut this year. (Some of the discount reflects good workers' comp. experience in "packaged" casualty programs.) Severity is rising faster than local inflation for much the same reason as in private passenger: " unitized" bodies require more extensive repairs than panelled cars, smaller cars have worse accidents, people are recovering a greater portion of their economic loss, more thefts occur, and so forth. Such factors added four points to inflation.

Loss severity benefits from the slower growth in truck and auto values caused by lower inflation. A recession also reduces exposures. The industry should bring most of the reduction in severity to the bottom line. This will be the major positive factor in the line as it is unlikely premiums will grow even as fast as slowed losses. Approximate balance between growth in premiums and in losses will be achieved in 1983. ROE should drop to 7 per cent in both years. During 1982, this low return will be sufficient to end competition. It takes, however, a year for this to be reflected strongly in earned premiums.

[illegible]

[illegible]	Prem. Wrt.	$ Δ	Prem. Ern.	$ Δ	[illegible]	$ Δ	Loss Exp.	$ Δ	Exp.	$ Δ	Pol. Div.	Und. Prt.	Δ Pol. Exp.	Adj. Und. Prt.	Comb. Ratio
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	1	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	1	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	1	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	1	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

	[illegible]	$ Δ	[illegible]	$ Δ	[illegible]	$ Δ
Prem. Wrt.	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	17
Prem. Earned	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Losses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Loss Exp.	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Expenses	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Pol. Div.	[illegible]		[illegible]		[illegible]	
Und. Prt.	[illegible]		[illegible]		[illegible]	
Δ Pol. Exp.	[illegible]		[illegible]		[illegible]	
Adj. Und. Prt.	[illegible]		[illegible]		[illegible]	
Loss Ratio	[illegible]		[illegible]		[illegible]	
Loss Exp. Ratio	[illegible]		[illegible]		[illegible]	
Exp. Ratio	[illegible]		[illegible]		[illegible]	
Pol. Div.	[illegible]		[illegible]		[illegible]	
Comb. Ratio	[illegible]		[illegible]		[illegible]	

[illegible]

[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]	[illegible]

Inland Marine is less affected than other lines by competition. Still, rates were cut 5 per cent last year for commercial customers. Rates have not kept up with inflation, so the line is operating at an underwriting loss. In total, it shows a profit in excess of $100 million, which equals a 15 per cent ROE. Good catastrophe experience was a big factor in producing so large a profit--with normal losses, the return would not have been nearly so good.

Rates should begin to rise in the next few months, but various specialty covers will remain quite competitive. Slower growth in the nominal value of inventories, reduced new construction, and slower growth in cargo (all caused by reduced inflation and a recession) will affect growth in both premiums and losses. It is unfortunate that the impact of these moderating forces will be greater on premiums than on losses. We expect a run-up in underwriting losses early in 1982 followed quickly by price increases and, eventually, improved results.

TABLE XIV
ALL OTHER LINES
STOCK COMPANY EXPERIENCE
($ AMOUNTS IN 000,000)

	Prem. Writ.	$ Δ	Prem. Earn.	$ Δ	Losses	$ Δ	Loss Exp.	$ Δ	Exp.	$ Δ	Pol. Div.	Und. Pft.	Δ Rpd. Exp.	Adj. Und. Pft.	Comb. Ratio
1981	8145	(2)	8075	(3)	5532	(10)	325	(11)	2500	2	9	(1600)	27	(1533)	101.7
1980	[illegible]	5	[illegible]	12	[illegible]	18	362	9	[illegible]	8	8	(1543)	18	[illegible]	[illegible]
1979	[illegible]	7	7814	4	5013	5	333	3	2333	11	(13)	[illegible]	110	(137)	101.3
1978	7380	13	7106	13	4770	10	322	18	[illegible]	12	6	[illegible]	115	35	[illegible]
1977	[illegible]	14	[illegible]	13	3790	15	[illegible]	22	[illegible]	17	7	(211)	9	[illegible]	[illegible]

	L-1981	$ Δ	[illegible]P	$ Δ	1983P	$ Δ
Prem. Writ.	8145	(2.2)	8410	3	[illegible]	6
Prem. Earned	8075	(2.5)	[illegible]	3	[illegible]	9
Losses	5532	(10.2)	5810	[illegible]	[illegible]	9
Loss Exp.	325	(10.8)	359	10	410	16
Expenses	2500	1.7	[illegible]	5	[illegible]	7
Pol. Div.	9		10		20	
Und. Pft.	(1600)		[illegible]		[illegible]	
Δ Rpd. Exp.	7		0		3	
Adj. Und. Pft.	(1533)		[illegible]		[illegible]	
Loss Ratio	[illegible]		69.7		[illegible]	
Loss Exp. Ratio	4.0		4.3		4.7	
Exp. Ratio	[illegible]		[illegible]		32.2	
Pol. Div.	0.1		0.1		0.2	
Comb. Ratio	101.7		[illegible]		[illegible]	

Reinsurance (one-third) had worsening experience last year, although the largest component (General Re) managed a flat combined ratio. Rates have not yet turned up. The only sign of hope is the move by some of the major buyers of reinsurance to strong reinsurers at some price sacrifice. Treaty reinsurance cannot turn until the primary level has enough premium to pass on.

Health and disability (one-third) experience appears to have been good last year. This is written in a P-C company for tax reasons and should show breakeven underwriting to a small loss. Frequency stopped rising early in the year and rates caught up during the third quarter.

Marine (one-sixth) rates began to firm last year although both hull and cargo remained quite competitive. Lloyds remains ready to punish (with low rates) anyone who tries to take market share. Loss experience improved from a bad 1980.

Bonding (one-sixth) had an unusually good year, given high interest rates and weak construction activity. It showed only a small loss. Contractors are under ever greater strain. In the past, recessions have wreaked havoc on employee honesty.

Bonding and reinsurance should crack during 1982, the former due to external forces, and the latter due to declining rates versus rising losses. Little can happen to ameliorate these results given the small size of ocean marine and the nature of A&H.

[From the Washington Post, Mar. 26, 1982]

ALLSTATE SETS 24-HOUR RULE ON DISTRICT OF COLUMBIA RENTERS' POLICIES

By Molly Sinclair, Washington Post Staff Writer

Allstate Insurance Co., citing high theft losses and low ceilings on rates it can charge, is now refusing to write any new renters' policies in the District of Columbia unless the policyholder can guarantee someone will be home 24 hours a day.

District residents who already hold Allstate policies are not affected by the new requirement, which was adopted in November. But the company is turning down Allstate policyholders who move into the District and try to transfer their renters' coverage, as well as District residents applying for renters' coverage for the first time—unless they satisfy the 24-hour rule.

Allstate's action represents a departure from the way it typically operates in the rest of the country and contrasts with the practices of other major insurers, such as State Farm, Aetna, Geico and Fireman's Insurance Co. Spokesmen for those companies all expressed surprise at the Allstate move and said they are continuing to insure renters in the District regardless of whether they are at home around the clock.

James Montgomery, acting superintendent of the D.C. Department of Insurance, has expressed concern about possibly unfair discrimination against renters who work or attend school and therefore cannot qualify for Allstate coverage. He said he will meet with Allstate representatives Wednesday to discuss the 24-hour rule, which makes exceptions for things such as vacations and nights out but prohibits coverage if the policyholder has regularly scheduled absences from the home during the day.

"Hopefully, I can work something out informally with the company that will be acceptable rather than take formal action," said Montgomery, who can impose a fine or revoke or suspend the license of a company found in violation of local insurance laws against discrimination.

Allstate said its rule is not discriminatory. "We are in full compliance with the law," said David Rowe, a spokesman for the company, which now insures an estimated 3,000 renters in the District. He said that the rule applies only to renters, not house or condominium owners, and that the company has no plans to expand the restriction at this time.

Rowe said that the company, one of the giants in the insurance industry, has lost money for two years on its D.C. renters' insurance, which covers loss or damage of personal possessions. "Our losses and expenses were such that we were spending \$1.30 for every \$1 of premium taken in," Rowe said.

Those losses, he said, reflected thefts from D.C. homes. Rowe said that national studies have indicated that the losses from property left unattended for long periods of time generally are greater than losses from property occupied 24 hours a day.

At one point Allstate filed a petition with the D.C. Insurance Department asking for a higher rate ceiling on renters' insurance, so that the company could adequately recover expenses and losses, Rowe said, but the request was denied. He said the only other alternative was for Allstate to limit its exposure to renters' theft losses by refusing to issue new policies to tenants who are not home all day.

Allstate and other insurers normally offer two different renters' policies at two different prices. Renters who have someone on the premises 24 hours a day typically are eligible for the company's standard, less-expensive policy. Those who are absent part of the day are offered the higher-risk policy, which may cost as much as 50 percent more than the standard coverage.

In Arlington, for example, the Allstate standard renters' one-year policy for contents worth \$30,000 in a brick high-rise apartment sells for \$106 while the Allstate Indemnity higher-risk policy for the same tenant would be \$160.

But in the District, where the cap on renters' insurance for contents worth \$30,000 is \$107, Allstate traditionally has sold only the standard policy. Until November, when the rule changed, that policy was available to renters regardless of the number of hours they spent at home.

One 34-year-old woman who moved here recently from Memphis [illegible] her Allstate policy because of the occupancy rule. She said she had been with [illegible] 10 years and had never filed a claim. But when she co[illegible] the [illegible]ut transferring her renters' policy to her new Chevy Chase [illegible] down because of the 24-hour occupancy requirement.

The woman checked with several other companies and finally [illegible] policy from one of them.

The other major insurers in the District, scratching their heads over Allstate's decision, say they intend to keep offering renters' insurance without the occupancy requirement.

Geico, for example, which has 4,252 renters' policies in force in the District, "will write almost any kind of policy as long as the property is in good shape and we don't have too much concentration in one area," according to company vice president August Alegi. As for Allstate's move, he said, "I really don't see their rationale."

Aetna, with 3,326 renters' and condominium contents' policies, does not have the 24-hour rule, said spokesman Bob Nolan.

State Farm, although it reports a near doubling of losses from tenant policyholder theft claims between 1979 and 1981 in D.C., says it has no such rule and no immediate plans to impose one.

"Cutting off new business is kind of an extreme step that we don't like to take unless we have to," said David Hurst, a company spokesman. "It would give our agents one less product to sell in the marketplace . . . and our loss experience isn't bad enough for us to do that."

Mr. VALANZANO. I would like to make one statement with regard to the contracts for the takeover of the flood insurance program. When we get into a comparison of what the contract was and what the cost per policy was, we should remember two things, that the NFIA policies and their costs were determined on the basis of a decentralized system, and that NFIA could have centralized that system, thereby cutting costs. In addition, the NFIA paid State premium taxes of approximately $4 million, which was a cost factor, and also retained possible liability for losses. Therefore we cannot necessarily equate the NFIA cost directly with the EDS cost since in many cases we are dealing with a far more extensive operation with retained liability on the part of NFIA, and EDS did not pay State taxes.

I believe that is it Mr. Chairman.

Chairman GONZALEZ. Thank you very much. You do not have any questions?

Mr. FRITZEL. Mr. Chairman, I would like to submit for the record an article which appeared in this morning's Washington Post, "Insurance Firm May Ease Rules." It is an article on a meeting which Allstate Insurance Co. had here with the District of Columbia Superintendent of Insurance discussing their rules, after which they agreed to reconsider their rules. I would like to submit that for the record, too.

Chairman GONZALEZ. Without objection, so ordered.

That was in today's Washington Post?

Mr. FRITZEL. Yes.

Chairman GONZALEZ. Identify it for the reporter.

Mr. FRITZEL. It was buried in the back sections, but it was in the paper today.

[The referred-to Washington Post article follows:]

[From The Washington Post, Apr. 1, 1982]

INSURANCE FIRM MAY EASE RULES

Two Allstate Insurance Co. executives agreed yesterday to consider relaxing the company's rule that new applicants for renters' insurance in the District of Columbia must have someone in their homes 24 hours a day.

The requirement was imposed last November, company officials said, because of high theft losses and low ceiling rates in the District.

James Montgomery, the D.C. insurance superintendent, met for two hours yesterday with the two Allstate executives, Frank R. Montgomery (no relation) and Gene ?. Mulligan, who came from the company's headquarters in Northbrook, Ill., to dis-

cuss the requirement. Superintendent Montgomery had requested the meeting after expressing concern that the rule might discriminate unfairly against renters who work or attend school and are gone from their homes during the day.

Existing Allstate policyholders in the District are not affected by the 24-hour requirement. It applies only to those seeking an Allstate renters' policy for the first time in the District of Columbia.

In adopting the rule, Allstate departed from the way it typically operates elsewhere and from the procedures of other major insurers such as State Farm, Geico and Aetna. The procedure normally is to offer insurance at regular rates to renters who have someone at home during the day and, in cases where they are not home, to issue the policy at a higher rate.

During the meeting, Superintendent Montgomery asked Allstate to consider introducing a policy with a larger theft-loss deduction—the threshold amount above which the company is responsible—and a lower premium. A second possibility, he said, would be for the company to accept other security measures, such as deadbolt locks or building security systems, in cases where the tenant's home was vacant during the daytime.

"They said they would give serious consideration to these options," Montgomery said. He said Allstate agreed to respond within 30 days.

Chairman GONZALEZ. I know that I had a question, but the hour is very late, and we are very grateful for your patience and your generosity. Please know how grateful we are for the time you have taken.

Mr. Jones.

Mr. JONES. Mr. Chairman, I would like to state for the record that regarding the crime insurance problem in the District of Columbia, as of January 1981 there were only 287 commercial policies written in the District of Columbia.

Chairman GONZALEZ. You mean crime insurance?

Mr. JONES. Crime insurance. There were only 287 policies written as of January 31, 1982.

Chairman GONZALEZ. Do you have an idea of how that compares with prior years?

Mr. JONES. I could check that, Mr. Chairman, and furnish that for the record.

Chairman GONZALEZ. I think it would be important, because the 287 policies, without some reference point, would be very hard to evaluate that program in the District.

[At the request of Chairman Gonzalez, the following additional information was submitted for inclusion in the record by Mr. Jones:]

RESPONSE RECEIVED FROM MR. JONES

During the Subcommittee's legislative hearing on April 1, 1982, Mr. Barry Mersky, Washington, D.C. Insurance Agent for the Globe Insurance Agency, testified to the enormous insurance market which would go unserved if the federal crime insurance program was not extended beyond September 30, 1982. I agree that there may exist within the inner city an availability and/or affordability problem for crime insurance in the private insurance market. However, this problem exists among those risks which are classified as high-risk or those risks which are uninsurable.

We believe a problem would exist if there were only one risk not able to purchase insurance in the private market. We do not agree, however, that the crime insurance situation in Washington, D.C. is a national problem. We contend it is a local rather than a national problem. A total of 412 federal crime insurance policies were in force in the District as of February 28, 1982. If the crime insurance problem was of national consequence, in our opinion, more policies would have been purchased. This does not indicate that a national solution is necessary to resolve wl [illegible] crime insurance problem may exist in the District of Columbia. This is a

which can be solved by local officials in an effort to correct that communities' crime insurance problem.

The federal crime insurance policy is issued for a period of one year. The following chart shows the number of crime insurance policies in force in the District of Columbia on the last day of February.

Year	Residential policies in force	Commercial policies in force	Total
February 1982	132	280	412
February 1981	167	287	454
February 1980	178	303	481
February 1979	144	280	424
February 1978	120	286	406
February 1977	100	277	377

The point we wish to demonstrate, is that if the problem were so serious as to warrant a national program, more policies would have been purchased over the past six years.

Mr. Chairman, there may be a crime insurance availability and affordability problem within the District, but a national program is not needed to solve this local problem.

Chairman GONZALEZ. I think the record also ought to show that the District should not bear the onus of a reputation, because let me assure you that in my own area it is a problem.

As long as it is in the record. Of course Mr. Hunter will have a copy of the transcript, and he can do the same. I was saying that very horrible crimes can occur where you do not have the density but maybe a high level of poverty. But I always feel that density is a tremendous factor of crime in areas such as the District, Philadelphia and New York. Yet this is not restricted to dense Northeast areas. The pattern of crime seems to concentrate on the small business, the convenience store, the drive-in stores, where we have had horrible circumstances of death even in San Antonio. We have had a poor airman stationed at a local Air Force base trying to earn a little extra money by working night shifts at a drive-in convenience store, and being shot dead even though he was not offering any resistance. We had a series of such crimes as though it came in waves. I do not know of any kind of protection against such crime. It somewhat diminished because the bus drivers in my home city were not permitted to carry any currency, and I believe this is the practice in the District of Columbia.

Some thought that such crime would happen only in the District of Columbia or New York, but I am saying it is a national epidemic in all communities. And I voted for the original insurance program because it did have national implications, even though the record shows that the heavy and perhaps disproportionate concentration of use to about four States. But it does not detract, in my opinion, from the criterion of national policy. I am still of that opinion, but let me say that I respectfully consider your views and your recommendations, and I am sure every other member of the subcommittee does. Thank you very much.

This afternoon's hearings continue the 1982 basic legislative hearings. We will continue to have hearings in the field and here in Washington on the continuing crisis in the housing industry, the

effects of the President's or the administration's budget on the economy and on the economic viability of our cities.

I wish to thank not only all the members of the subcommittee and the staff, but every one of those witnesses that have traveled many miles to be with us and helped us with these hearings. So the subcommittee stands adjourned until further call of the Chair.

[Whereupon, at 5:32 p.m., the subcommittee was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR INCLUSION IN THE RECORD

STATEMENT OF THE HONORABLE PAT WILLIAMS
ON H.R. 5731
BEFORE THE SUBCOMMITTEE ON HOUSING
AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

April 23, 1982

The Subcommittee on Housing and Community Development has taken a careful look at the current housing problems in this country, and at the Administration proposals for federal housing programs, and has wisely developed an alternative approach which addresses directly housing needs and which continues the fifty-year federal commitment to provide adequate and decent housing to all Americans. I am pleased to be sponsoring this bill, H.R. 5731.

One of the objectives of H.R. 5731 is to ensure the future existence of Public Housing. The bill provides adequate operating subsidies for the Public Housing program in fiscal year 1983, and provides for construction of badly needed new Public Housing units. The Housing Authorities in my District support the bill. However, in discussions with the Housing Authorities from Montana, a concern was raised that although the bill allows sufficient operating subsidies for fiscal year 1983, it does not ensure that such subsidies will be available for fiscal year 1984. Since operating subsidies for the Public Housing program have grown rapidly in the past ten years, and given the current budget-cutting fever here in Washington, I appreciate their concern, and I asked them for their suggested solution. They told me that an effort should be made to devise a Public Housing rent structure

that would provide a stable financial base for management. They asked for the return of authority to the local level to establish a viable, reasonable rent system. They said that with this authority they would be able to reduce their need for operating subsidies and would be able to continue to provide decent, affordable housing for those who need it.

As the Subcommittee marks up H.R. 5731, I hope serious consideration will be given to an amendment to allow this type of rent flexibility on a voluntary basis. Such a change could allow many housing authorities a new lease on future, vigorous existence. It would also result in substantial savings to the federal government.

Thank you.

Pat Williams

American
Planning
Association

1776 Massachusetts Ave. NW
Washington, DC 20036
Phone 202.872.0611

April 7, 1982

The Honorable Henry B. Gonzalez
Chairman, Housing and Community
  Development Subcommittee
House Banking, Finance and
  Urban Affairs
2139 Rayburn House Office Building
Washington, D.C. 20515
Attn: Jean Raupach

Re: HR 5731, The Housing & Community
Development Act of 1982

Dear Mr. Gonzalez:

On behalf of the American Planning Association, we would like to take this opportunity to submit for the hearing record comments on your bill, The Housing and Community Development Act of 1982, HR 5731.

As the national organization of over 21,000 city and regional planners -- including elected and appointed officials at all levels of government, professional practitioners, educators, interested citizens and students -- the American Planning Association is very concerned about our nation's housing supply. Our membership belongs to 46 Chapters covering virtually every state and Congressional district. The Association's primary objective is to advance the "art and science" of planning for the unified development of communities, cities, regions, states and the nation.

Within the last year, the Association adopted, in consultation with its broadly-based constituency, a set of policies reflecting planning goals for contemporary American society. Several have direct relevance to your bill. Particularly noteworthy is our reaffirmation of the national housing goal to provide "a decent home and a suitable living environment for every family," which was established in 1949 and reiterated through the years in various pieces of Federal housing legislation.

APA's comments on the Interim Report of the President's Commission on Housing identified a growing gap between household income and the cost of housing, and between goals for the construction of new housing and the actual production of such housing. In accordance with its

adopted policy, APA is concerned that future Federal housing policy be geared to meeting not only financial but also physical housing needs so that the supply of housing can be increased. At a time when we have reached the lowest level in new housing construction since 1946, and available resources for rehabilitation have been reduced, it is vital that the supply of housing be expanded and upgraded.

Many aspects of the Housing and Community Development Act of 1982 (HR 5731) are more responsive than the President's budget proposals in dealing with the national housing supply. For example, the President's proposals eliminate multi-family housing production, the Section 235 homeownership program, and Section 312 rehabilitation program. HR 5731 proposes $1.3 billion for new rental rehabilitation which could produce 60,000 - 100,000 new units, retains Section 235 for 15,000 units and provides $69 million for Section 312 loans. Furthermore, the President's proposals provide no program for emergency mortgage relief. HR 5731 provides funds of $760 million for 76,000 single family homeowners. Thus we support the general appropriations of HR 5731 that deal with the nation's housing supply.

We are concerned, however, that HR 5731 and most other recent housing proposals make no provision for the maintenance of a planning process. The Housing and Community Development Act 1974 established requirements for localities, states and areawide planning organizations to prepare housing elements. These provisions should now be revived so scarce housing resources might be more efficiently guided and coordinated between and among the various levels of government.

If you have any questions on our position, please do not hesitate to contact George Marcon, AICP, APA's Director of National Planning Policy at 872-0611.

Sincerely yours,

Lloyd Lapp, AICP
Member, Board of Directors

ASSOCIATION of BANK HOLDING COMPANIES

DONALD L. ROGERS
PRESIDENT

730 FIFTEENTH STREET, N.W., WASHINGTON, D.C. 20005
(202) [illegible]

March 15, 1982

Honorable Henry B. Gonzalez, Chairman
Subcommittee on Housing and Community Development
House Committee on Banking, Finance
and Urban Affairs
Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Our Association follows the policy of taking positions only on legislation directly affecting bank holding companies and does not become involved in legislation dealing with our competitors. Therefore, we have not asked for an opportunity to testify on the various proposals currently pending before your Subcommittee to "bail out" the thrift industry. However, we do believe it is important to point out the desirability of utilizing existing private resources before undertaking the expenditure of untold billions of taxpayers dollars.

As you know, the Justice Department has advised the Federal Reserve Board that the Board has full authority under section 4(c)(8) of the Bank Holding Company Act to permit bank holding companies to acquire thrift institutions. Thus, by a very simple action, the Board could make available immediately the financial and managerial resources of an industry with almost $2 trillion in assets.

In brief, we urge you to give the free enterprise system a chance to function before you authorize a massive and unprecedented federal legislation.

Sincerely yours,

Donald L. Rogers

Donald L. Rogers

Statement by
Byron J. Matthews, Secretary
Executive Office of Communities and Development
Commonwealth of Massachusetts

on behalf of
The Council of State Community Affairs Agencies

Mr. Chairman, the following statement is submitted by the Council of State Community Affairs Agencies (COSCAA). COSCAA represents state departments of community affairs, which are executive-level agencies of State government with significant responsibilities in community development, housing, local economic development, and State-local relations. We are thankful for the opportunity to record our views on housing, a most critical domestic policy issue of 1982.

Many witnesses appearing before the Subcommittee have already very eloquently and very emphatically described the housing problems facing low income and moderate income households throughout this country. We will not repeat any such nation-wide statistics here and only underscore the point that COSCAA believes that the issues of housing affordability and housing availability cannot be ignored.

In Massachusetts the problems are also severe. We are facing a period of record-high housing demand, with the "baby boom" generation growing up and entering the housing market in growing numbers. We estimate the total demand to be about 35,000 housing units per year. And yet, housing production has fallen to its lowest point since World War II. In 1981, only about 11,000 homes were built in Massachusetts — less than one-third of the need. At the same time, housing affordability has become a critical problem. Since 1973, the monthly carrying costs of purchasing the average priced home have more than tripled, from $368 to $1,068. In 1973, 72% of the Massachusetts households could afford homeownership; today, that figure has declined to less than 11%. We are all hurt by such an extreme housing shortage, but particularly hard hit are the poor and the elderly.

We in Massachusetts have not shirked our responsibility, and are using our own resources to deal with these housing problems. We have built and operate — entirely with state funds — about 56,000 units of public housing for the elderly and for low-income families. We will spend over $110,000,000 this year for public housing construction and modernization. We spend about $65,000,000 each year to operate state-aided public housing. Again, all these figures are entirely from state tax revenues.

While Massachusetts represents an excellent example of State commitment to and competency in housing - a point that we will address later on - the Federal government must continue its commitment to the goal of decent housing and must maintain an important presence in addressing our housing need. COSCAA is very concerned about the apparent absence of nearly any production program for lower income households in the Administration's proposals.

We all recognize the need to control expenditures and reduce the Federal deficit. Yet, as State and local government officials have pointed out to this Subcommittee and others in Congress, State-local programs bore much more than their fair share of budget reductions under the Administration's proposals. On the other hand, H.R. 5731 will continue a housing commitment at the FY 82 level.

The Administration's proposed housing programs are not yet available in detail, but HUD's FY 83 budget proposals make it clear that Congress must take the initiative to enact a much-needed housing production program. The Rental Housing Production and Rehabilitation Act of 1982 is such a commendable initiative.

Its short-term assistance responds to a major criticism of the Section 8 production program; its flexibility provides a necessary capability to respond to unique and varying needs and circumstances; the role given to State and local governments begins to recognize that all levels of government have complementatry skills and resources, each of which is necessary for meeting our housing needs; its targeting to areas of need helps ensure a market responsiveness; and its incentive for leveraging promotes cost-effectiveness. These characteristics show that the proposal was crafted with perception and discernment.

There are, however, several suggestions we respectfully make that we feel will improve the proposal. COSCAA believes that a better way to operate a housing production program is through block grants to States and appropriate local governments. We would suggest that "entitlement" status be achieved through some measure of capability and not solely through a criterion that may be unrelated to capability. For States, providing an initial option, as was done with the State CDBG program, may be an appropriate strategy. A block grant would introduce a measure of certainty and permit increased effectiveness through the ability to plan, schedule, and coordinate housing production with other Federal, State, local and private sector resources. Additionally, we feel that such a change would heighten the responsiveness and accountability of decision-making.

In addition, since H.R. 5731 includes continuation of the 202 program for housing the elderly, we would recommend that the program be amended so as to be limited to only those communities willing to accept housing for low-income families. While housing for the elderly has gained widespread popularity,

housing for low-income families has not gained the same wide acceptance. By linking the two programs in Massachusetts — that is, if a community wants elderly housing, it has had to also apply for family housing — we have been able over the last two years to encourage eighty communities (51 of these for the first time) to develop 800 units of scattered-site family housing. A similar linkage could be established with the popular 202 program. Moreover, 202 projects should be required to respond to specifically identified state and local housing needs.

Related to production, the Administration programs a substantial rescission of FY 1982 and earlier appropriated funds for new construction. Communities, developers, and citizens have invested much time and money in preparation for construction from anticipated reservations. These units are not only needed, but they can quickly provide employment opportunities and some economic stimulus.

Also, we support the continuation of the public housing program and the authorization of the existing level of funds for new public housing construction, modernization, and operations.

The Administration proposes a modified certificate program. COSCAA supports a housing voucher-type program in concept that is built on the experience of the Section 8 Existing Housing Program and provides some degree of flexibility to administering agencies - understanding, of course, that a voucher program cannot take the place of a much needed production program. The Administration's proposal is somewhat troublesome because of its low level of funding, its seeming inability to respond to rising shelter costs over time, and its

proposal to count food stamps in determining income. We are concerned that this latter proposal would very adversely affect elderly households and may be difficult to administer. On the other hand, the Administration's intent to move away from using Fair Market Rent in setting the payment standard and to introduce a "shopper's incentive" would seem to have some merit.

Last, we support the Subcommittee's efforts to maintain the CDBG and UDAG authorizations. Massachusetts is one of the many States that will mange the State CDBG in 1982 -- in fact, we are already soliciting applications. Our State CDBG program was designed in thorough consultation with local governments, is oriented towards lower income households, and will meet the particular housing, community facility, infrastructure, and local economic development needs and priorities of our State and localities. We are convinced, and I think I can say that our local governments are convinced as well, that we can design and implement this program in a way that meets national objectives and is at the same time more sensitive to our problems and circumstances and more cost-effective than a nationally administered program with its national standards.

Our commitment to and action in providing decent housing and our involvement in the CDBG program reflect our belief that States should have a significant role in Federal housing and community development policies and programs. The Community Development amendments passed by this Congress last year, the Administration s proposed Rental Rehabilitation Block Grant, and the Rental Housing Production and Rehabilitation Act proposed by the Chairman and Representative Schumer begin to address that goal.

We thank the Subcommittee for the opportunity to submit this statement, offer our assistance to you and your staff, and would be most pleased to respond to any questions or prepare additional materials if you so desire.

NATIONAL CONSUMER FINANCE ASSOCIATION

1000 SIXTEENTH STREET N W WASHINGTON [illegible]

NCFA

April 9, 1982

The Honorable [illegible]

[illegible]

Finance Company Sources Of Funds

Although the consumer finance industry has generally not participated n the secondary market consumer finance companies compete with all other l nes of business in the funds market. The largest percentage d str bution of capital for lending by consumer finance companies comes from long term debt (excluding subordinated debentu es , which amounted to 33 2% of the source of funds at the end of 1979. Other sources of funds include: commerc al paper, short term debts, thrift certificates, and company capital and surplus

The opening of the secondary market to consumer finance companies under the Home Improvement Loan Program operated by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association provides the first open ng of this market for the consumer finance ndustry. Although only one major corporation has sold $50 million of second mortgage paper through this program, other consumer f nance companies are studying the applicability of the secondary market to their capital needs.

NCFA wishes to emphasize that these real estate secured mortgages are often used as part of a creative financing package to purchase homes The National Association of Realtors has estimated that one-third of the houses purchased in the United States in the last year involved such secondary financing. Further, those second mortgages used for home improvements stimulate the construction industry and improve the condition of the nation's housing stock.

Sections 512 and 513

NCFA s opposed to Section 512's limitation on the mortgage purchase authority of both FNMA and the FHLMC to purchase participations in mortgages secured by second liens on residential real estate.

NCFA is also opposed to Section 513's imposition of limitations on the amount of second mortgages eligible for purchase through changes in either the lower of the dollar amount of a second mortgage eligible for purchase or the loan-to-value ratio of these loans. The proposal to limit the maximum loan-to-value ratio to 80% of appraised value by statute simply limits access to second mortgage funds where facts would warrant a higher ratio. The decision to make such a loan should be made by a lender on a case-by-case bas s after consideration of the security and other factors underlying the transaction.

Finally, NCFA opposes the restriction of the secondary market to second mortgage loans made to owner occupied residences as this may preclude access to financing for the rental housing industry.

Summary

Although the consumer finance industry's participation in this area is still embryonic, both FNMA and FHLMC representatives have addressed NCFA conventions and seminars. NCFA believes that limiting this program while it is still in its pilot stage would be premature. Certainly, the higher yield second mortgages can provide a vehicle by which either FNMA and FHLMC can make up losses incurred by their more traditional first mortgage lending program.

The second mortgage market is a growing facet of real estate lending and is providing a vehicle for the purchase of new homes at levels never before seen by traditional first mortgage lenders. The consumer finance industry has the expertise and the experience in this area and respectfully urges that no curtailment of access to the secondary market be imposed by the Congress.

Respectfully submitted,

Walter R. Kurth
President

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RESOLUTION TO URGE CONTINUED FEDERAL GOVERNMENT SUPPORT FOR LOW AND MODERATE INCOME HOUSING

ANALYSIS OF THE PRESIDENT'S COMMISSION ON HOUSING INTERIM REPORT AND THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1983

March 4, 1982

New Detroit, Incorporated is an urban coalition established after the civil disturbances in 1967. Since that time leaders from business, labor, the professions, government, education, clergy and the community have explored means to revitalize the City. The coalition, funded by Detroit area corporations and foundations, focuses upon social and economic issues through activities undertaken in various program areas including education, employment, health and substance abuse, minority economic development and housing.

On March 4, 1982, the New Detroit Board of Trustees adopted a resolution urging the federal government to continue its support of low and moderate income housing. A report analyzing the President's Commission on Housing Interim Report and the President's Budget for Fiscal Year 1983 supplements the resolution. Staff research indicated that a significant retrenchment in commitments to provide adequate housing would occur should pending proposals be effectuated.

In carrying out its role as a catalyst to make existing institutions more responsive to the needs of the poor and minority groups, New Detroit is informing legislators and organizations concerned about housing policy of our position. It is incumbent upon us to support those policies which realistically assess and address the needs of the poor and, similarly, to oppose those policies which ignore the persistence of substandard housing conditions in many parts of the country. Both the President's Budget and the Commission's Interim Report seem to accept or ignore the fact that millions of Americans, particularly the poor, face serious housing problems especially in older cities and rural areas.

We strongly believe the federal government would be ill-advised to abandon its historic role in bridging the gap between housing need and housing supply. Copies of the New Detroit resolution and report are attached.

Contact: Mittie R. Olion, Director
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March 4, 1982

RESOLUTION

TO URGE CONTINUED FEDERAL GOVERNMENT SUPPORT
FOR LOW AND MODERATE INCOME HOUSING

New Detroit, Inc.
Board of Trustees

WHEREAS, New Detroit, Incorporated is a coalition comprised of leaders from business, labor, the professions, government, education, clergy and the community organized for the purpose of improving the quality of life for minorities, the poor and disadvantaged; and

WHEREAS, the Reagan Administration has been retreating from all areas of assistance to low and moderate income persons, including the area of housing, and

WHEREAS, the President's Commission on Housing acknowledges that a significant number of persons, particularly the poorest, confront serious housing problems; and

WHEREAS, the President's Budget for Fiscal Year 1983 essentially recommends elimination of the federal government's support of new housing construction and substantial rehabilitation programs for low and moderate income households; and

WHEREAS, the President's Budget for Fiscal Year 1983 proposes to substitute a modified voucher program providing lower levels of assistance, for Section 8 Existing Housing income support payments and the President's Commission on Housing has also recommended that vouchers replace public housing rent subsidies; and

WHEREAS, the modified voucher program will only add assistance for a few (30,000) low income families in its initial years and only 66,000 total in five years, as contrasted to 1980 support for 114,000 additional families by the program they are to replace; and

WHEREAS, the modified voucher program would provide lower levels of support (under $2,000) for housing assistance for the few who would be served and fail to provide equality of treatment by providing assistance to all of those eligible; and

WHEREAS, Detroit has 30 percent substandard housing that requires replacement or rehabilitation and has a depressed housing construction industry which will not be able to respond to Detroit's needs if government incentives are withdrawn; and

WHEREAS, the President's Budget for Fiscal Year 1983 proposes substantial withdrawal of federal assistance for operating subsidies for public housing and crushing rent increases on tenants in public housing as a result thereof; NOW THEREFORE

BE IT RESOLVED, that New Detroit urges the Administration and Congress to adhere to the national goal of providing a decent home and a suitable living environment for <u>every</u> American as set forth in the Housing Act of 1949; and

BE IT FURTHER RESOLVED, that New Detroit urges that the Administration and Congress recognize that the adequacy and availability of housing vary regionally and that Detroit experiences a shortage of safe, decant, sanitary housing for low and moderate income persons; and

BE IT FURTHER RESOLVED, that New Detroit opposes the Administration's proposed withdrawal of federal government support of production subsidy programs, such as Section 8, which have proven effective in addressing housing needs in Detroit; and

BE IT FURTHER RESOLVED, that New Detroit urges the Administration and Congress to continue a targeted new construction and rehabilitation subsidy program, such as Section 8, to those areas, such as Detroit, in need of housing for low and moderate income persons who will not otherwise be adequately served by the private sector; and

BE IT FURTHER RESOLVED, that New Detroit urges the maintenance of the Section 8 Existing Housing program or similar subsidy mechanism at least at current levels; and

BE IT FURTHER RESOLVED, that New Detroit urges that the Administration withdraw and that Congress reject proposals to cut substantial amounts of funding from operational subsidies for the needy, low income tenants of public housing that if implemented will cause great hardship and result in large increases in rent for those least able to afford such additional financial burdens; and

BE IT FURTHER RESOLVED, that copies of this resolution and report be forwarded to the immediate attention of Congress, the Secretary of Housing and Urban Development, and appropriate organizations concerned with the future of housing policy in this country; and

BE IT FURTHER RESOLVED, that New Detroit's Chairman and President explore avenues for media coverage on housing problems and issues in Detroit as related to proposals in the President's Commission on Housing Interim Report and the President's Budget for Fiscal Year 1983;

BE IT FINALLY RESOLVED, that the Board of Trustees of New Detroit, Incorporated authorizes Level I lobbying for the communication of this position.

AN
ANALYSIS

of

the
PRESIDENT'S COMMISSION ON HOUSING
INTERIM REPORT

and

the
PRESIDENT'S BUDGET
FOR FISCAL YEAR 1983
(housing component)

INTRODUCTION

New Detroit, Inc., was founded as the country's first urban coalition to tackle the root causes of the civil disturbances that occurred in 1967. This coalition is comprised of leaders from business, labor, the professions, government, education, clergy and the community. New Detroit's broad objective is to improve the quality of life for minorities, the poor and disadvantaged through the work of eleven committees and two caucuses.

New Detroit's Neighborhood Stabilization and Housing Committee is specifically responsible for addressing the availability of safe, decent and sanitary housing in viable communities for all who seek it. It has formed a Housing Policy Subcommittee in response to concerns about current trends in national housing policy. The Subcommittee was given two charges: 1) to review the President's Commission on Housing Interim Report and the President's Budget for Fiscal Year 1983; and 2) to prepare a written analysis of those documents. This report is the result of the work by the Housing Policy Subcommittee.

As defense expenditures have increased, the weight of fiscal cutbacks to reduce budget deficits has fallen disproportionately on housing programs. Great numbers of Americans need assistance to secure decent housing, especially the poor. The change in housing policy emanating from the Reagan Administration became apparent early in 1981 with the elimination of funding for the Section 312 low-interest rehabilitation loan program that primarily benefited low and moderate income homeowners. Since that time, the President's Budget for Fiscal Year 1983 has proposed to make severe cuts in Section 8 and public housing subsidies. It is apparent that a substantial modification of the federal government's attitude toward housing policy prevails.

In the Housing Act of 1949, the federal government for the first time identified as its objective the provision of decent homes and suitable living environments for <u>all</u> Americans. The preamble to the act declared that

> the general welfare and security of the nation and the health and living standards of its people require housing production and related community development sufficient to remedy the serious housing shortage, the elimination of substandard and other inadequate housing through the clearance of slums and other blighted areas and the realization as soon as feasible of the goal of a decent home and suitable living environment for every American family, thus contributing to the development and redevelopment of communities...

The 1949 Act established the basis for widespread federal support of housing and community development activities; in the following two decades several additional programs were enacted that broadened the federal government's role in this area.

The President's Budget for Fiscal Year 1983 essentially proposes to repudiate any future role of the federal government in the construction of housing for low and moderate income persons. Almost without exception the Budget supports the trend to denigrate the national responsibility for national problems and concerns. The effects of this reduction of the federal government's role will lead to the accelerated demise of the housing industry, assure virtually no housing production for any but the most wealthy and accelerate the abandonment of housing quality standards for governmentally assisted low and moderate income rental units. The Administration has failed to realistically address the causes and effects of escalating interest

rates which have contributed to the inability of large segments of the population to purchase housing.

BACKGROUND

The President's Commission on Housing, in its October 1981 Interim Report, has provided the basis for many of the Administration's actions in the Fiscal Year 1983 Budget. The Commission was established by Executive Order to advise the President and the Secretary of Housing and Urban Development on options for the development of a national housing policy and the role and objectives of the federal government concerning the future of housing.

The Executive Order directs the Commission to:

> "Analyze the relationship of homeownership to political, social, and economic stability within the nation;
>
> review all existing federal housing policies and programs;
>
> assess those factors which contribute to the cost of housing as well as the current housing finance structure and practices in the country;
>
> seek to develop housing and mortgage finance options which strengthen the ability of the private sector to maximize opportunities for home-ownership and provide adequate shelter for all Americans;
>
> detail program options for basic reform of federally-subsidized housing..."

The Commission submitted its Interim Report in accordance with the President's directive. The Interim Report does not address the Commission's total charge, but rather concentrates on the enunciation of a broad set of principles and a housing policy framework to serve as guidelines for later deliberations and decisions. The only substantive recommendations call for the basic reform of federally-subsidized housing programs. Allegedly, the emphasis on federally subsidized housing programs is not a reflection of priorities formulated by the Commission, but rather an attempt to present important fiscal and programmatic issues that deserve attention for formulating the 1983 federal budget. The Interim Report merely reiterates the Administration's denunciation of a meaningful role in providing safe, decent and sanitary housing for all Americans. Since the New Deal, some fifty years ago, the federal government has played a major role in resolving national housing problems. This progressive approach has been attacked on three fronts -- actual cuts in program funding, additional cut-backs proposed in the 1983 fiscal budget, and the Interim Report. These actions will effectively dismantle policies and programs developed with over 50 years of bi-partisan political support.

BASIC PREMISE

New Detroit disagrees with the basic premise underlying the principles and the policy framework advanced by the Commission and carried out in the President's Budget. Three areas of concern are identified in the Interim Report: housing availability, adequacy and affordability. Affordability is cited as the most serious problem. However, the availability of decent housing units in viable communities and the adequacy of units to meet the shelter needs of a diverse population of elderly persons, large families

and single-person households have at least as much significance as affordability. While questions of affordability are important, the assumption in the President's Budget and his Commission's Interim Report that affordability is the most serious problem ignores the lack of units for those with low incomes, in particular localities. Failure to disaggregate national statistics is misleading.

In its statement of principle, the Commission believes that the nation must:

- Achieve fiscal responsibility and monetary stability in the economy;
- Encourage free and deregulated markets;
- Rely on the private sector;
- Promote an enlightened federalism with minimal government intervention;
- Recognize a continuing role of government to address the housing shelter needs of the poor;
- Direct programs toward people, rather than toward structures; and
- Allow maximum freedom of housing choice.

The principles put forth may be laudable and generally applicable to aspects of economic life in certain parts of the country, but they cannot be universally applied. A primary flaw in the principles is the absence of a geographical perspective. A national housing policy which avoids federal government responsiblity for assisting those in need and, which fails to take specific regional and local realities into consideration is faulty, both in applicability and practicality.

Two patterns emerge in the Commission's analysis of inadequate housing among various segments of the population. The incidence of inadequacy is far more common among renters than owners and it is concentrated at the bottom of the income distribution scale.

The Interim Report acknowledges the existence of between 3 and 10 percent substandard units among United States housing stock.[1] This discrepancy in statistics is related to varying measures of housing condition. The Commission seems comfortable with using the Congressional Budget Office definition of units "in need of major rehabilitation" which totaled 7.5 percent of 75 million units in 1977 consisting of 5.6 million households. The Interim Report further notes geographic concentrations of inadequate housing stock in rural areas, in the south, and in older large cities.

In the Detroit Housing Assistance Plan (1977-1980), over 53,000 occupied rental units are classified as substandard. This figure represents 30% of Detroit's total rental housing stock.[2] Additionally, inadequate housing is found to occur more frequently among certain types of households -- minority, female-headed and elderly. Despite great strides to improve housing during previous administrations, a shortage of safe, decent and sanitary housing exists in Detroit and nationally.[3] The federal government must continue to be involved in meeting that need.

The impediments to meeting the housing demand in this region are both supply and affordability. A federal program to resolve these problems must address:

-- high costs of construction

-- adequacy of financial resources to reach necessary levels of housing supply

-- increased costs of maintenance, repairs and energy

-- a shortfall in the renewal and upgrading of existing housing stock

-- effective planning to meet housing needs

Further utilization of public/private partnerships are essential to addressing the problems enumerated above; neither entity can ignore this responsibility. The Interim Report implicitly speaks to some of these issues; however, funding for the two programs designed to resolve the last two issues has been eliminated, i.e., Section 312 loans and 701 planning assistance. The loss of appropriations for Section 312 loans will deny homeowners the opportunity to obtain affordable financing for necessary improvements and repairs. The inexorable result of this policy will be to accelerate the deterioration of the housing stock increasing the likelihood of abandonment and the potential for overcrowding in those units that still remain habitable. Comprehensive planning efforts will be more crucial as the remaining housing programs are forced to operate with fewer dollars. Scarce resources should be schematically utilized for effective results.

RECOMMENDATIONS FROM THE INTERIM REPORT AND THE BUDGET

Details are absent from most of the recommendations included in the Interim Report. Additional research undertaken by various task forces and committees are to serve as the basis for elaboration in the final report due April 30, 1982. Concerns and responses to the recommendations in the Interim Report and the President's Budget are as follows:

1) Consumer Housing Assistance Grants

The proposal to implement Consumer Housing Assistance Grants) referred to as Modified Section 8 Certificates in the Budget) or "vouchers" to replace Section 8 programs is based upon plans to totally revamp the involvement of the federal government in housing production and rehabilitation. Essentially, all federal government assistance for these purposes will be eliminated if the President's Budget proposals are implemented.

A shortage of standard, affordable housing existing in Detroit and other areas will be virtually ignored if the federal government fails to provide some type of production incentive, such as Section 8 subsidies. This element of the Commission report, while providing funds to assist renters to afford existing housing, ignores bi-partisan policies that have called for a balance of new housing production and income support programs over the years.

The failure to assist housing production reflects a callous indifference to the plight of many Americans who live in areas where the private sector failed to construct housing unless incentives were available. Moreover, the abandonment of production programs exacerbates the effects of the Reagan recession which have impacted most severely on regions with the oldest housing stock. This is an ill-considered reversal of prior policies that had utilized assisted housing production to help provide some stability to the construction industry in times of severe economic downturn. Expanding Community Development Block Grant (CDBG) eligible activities to include housing construction as proposed, only camouflages the issue. These additional demands on scarce CDBG funds will pit the need for new construction of housing for low and moderate income households against other equally important needs without

increasing the funds available for all these purposes.

Few persons qualifying for vouchers under this program will receive assistance since this s not an entitlement program. Initial estimates of the proposed funding levels indicate that only 30,000 additional households would benefit in this program's first year (of 5 million eligible renters who pay over 30% of their income for rent).[4] Additionally, these 30,000 will be reserved only for specific rehabilitation projects, thus undercutting the increased mobility rationale for vouchers. Within the initial years, only a total of 66,000 additional fami..es will be aided. This compares poorly to 114,000 additional units in 1980 and 844,000 units since 1975. The criteria for qualifying for certificates will be households that have ncomes of less than 50% of the area median income and are paying more than 30% of their income for housing. The City of Detroit alone has 44,000 households that have incomes only 50% or less than the median income evel and who are paying more than 30% of their ncome for rent. According to the 1983 Budget the subsidy per voucher per year wi be under $2,000 as compared to $3,000 that made ava lable to ow income tenants under the Existing Section 8 program. Voucher recipients wi be required, moreover, to devote ncreased portions of their income for rent since preliminary plans were to fund vouchers at a constant figure for 5-year term without supplements for predictable inflationary rent increases. Unless steps are taken to maintain support for new construction and/or rehabilitation of existing housing stock, increased demands for housing along with losses in housing supply from housing deterioration will ultimately contribute to higher rental costs.

Facing the possibility of cuts in allocations for housing programs, New Detroit suggests that modifying the scope of the current Section 8 programs wou d more fairly absorb those decreases. Areas of the country where a lack of decent housing exists, as conceded in the Interim Report, should be given first priority for construction and rehabilitation subsidy programs. A targeted program to direct funds to areas most in need such as Detroit, would be more effective. Above all, federal government financial assistance for housing must continue.

The Administration proposes to "deregulate" the rental rates now in effect known as the fa r market rent, and allow the renters to select on their own any standard quality renta uni they want. New Detroit believes that in areas such as Detroit where shortage of standard quality rental units exists, the "deregulation" of the fair market rents wi l lead to an increase in the renta rates for both standard and substandard renta units. Where there i a documented shortage of standard rental units there will not be a desire on the part of andlords to imit or reduce their rents unless the federal government mai tains the fa r market rent guidel nes. The reduction in the amount of rental assistance from an average of $3,000 per year under the Section 8 Exist ng Program to $2,000 under the Modified Section 8 Housing Certificate Program will only serve to force renters to search for the "cheapest" rents, hence the lower quality housing units because they will not be able to afford anything e se. New Detroit bel eves that the proposal falls short without a uniform definition of standard quality unit"; without such a definition, renters wi be unable to depend on the enforcement of local housing codes by the federal government to insure reasonable quality standards across the country.

2) Improving the Availability of Adequate Housing

Improving the availability of adequate housing should continue to be a concern of federal housing policy.

a. New Construction Within the CDBG Program

The Administration proposes to add new construction to CDBG-eligible activities. Funds for this program, however are being cut which will force an unacceptable choice between alternatives. It will not be possible to maintain previous commitments. The Administration seeks to switch responsibility to local government for allocating fewer dollars to more users. Local responsibility for decision-making inherent in the CDBG program should only be expanded to include new construction if additional funds are appropriated.

b. Mortgage Revenue Bonds

Three options regarding the future of tax-exempt bonds are presented in the Commission's Interim Report. The option which offers flexibility to state and local authorities by allowing them to either use tax-exempt bonds or taxable bonds with subsidies from the federal government is preferable. State and local authorities should not be limited to one form of bonding capability or the other as proposed under the other two options. Recent trends in the bond market have adversely affected the sale of tax-exempt bonds while failing to promote the attraction of taxable bonds. Subsidies to eligible governmental authorities would allow for investments by a larger segment of the population unattracted to tax-exempt bonds: middle income investors and pension funds. Governmental authorities should be allowed to determine the feasibility of the two approaches depending upon their regional circumstances.

c. Rehabilitation

New Detroit agrees with the Commission's recommendation that owners of residential rental property should also receive rehabilitation tax credits as provided in the Economic Recovery Act. Currently, owners of non-residential structures between 30 and 39 years old receive a 15 percent tax credit for rehabilitation and owners of older structures receive a 20 percent tax credit. This incentive plan may help increase the number of standard housing units available for rent, but should not be considered as a replacement for direct federal efforts to provide additional new and rehabilitated residential units.

The 30,000 rental rehabilitation units called for in the 1983 Budget represent an insufficient support mechanism since the average allocation of $5,000 per unit will not permit substantial rehabilitation. The number of units to be assisted are simply inadequate relative to need.

d. Private Institutions

The Commission recommends that foundations and other organizations should be encouraged to sponsor and finance housing construction, rehabilitation and homeownership. This may be an unrealistic expectation, however, given the curtailment of funding for production. The disincentives for

private charity and the essential unavailability of government incentives to make projects feasible will discourage an active private role. This resort to the private sector cannot conceivably substitute for the decrease in new units resulting from the proposed withdrawal of federal government assistance for housing production.

e. Homeownership

The Commission proposed Individual Housing Accounts, similar to Individual Retirement Accounts, to allow first-time homebuyers a means of saving toward a down payment. The concept sounds plausible and deserves more attention although its cost implications need to be closely examined. The problems facing many lower-income and newly-formed middle income families currently unable to purchase homes may be aided. The requirements and guidelines of the program must be carefully developed and analyzed to determine the long-range impacts on federal revenues.

f. FHA Insurance Programs

New Detroit urges the continuation of FHA for meeting the needs of persons not adequately served by private sector financing. Rather than increasing reliance on private sector markets, attention should be focused upon expanding the scope of the program given conditions in private markets that serve fewer persons at present than in prior years.

The range of FHA programs should not be reduced since this has historically been a source for financing homewonership for those with moderate incomes. Proposals to modify the fee structure, the mortgage limits, and the provisions to protect home buyers, as HUD itself rendered, would make FHA insurance no longer attractive to those who traditionally rely on these programs. Additionally, the effectiveness of FHA would be restricted by limiting those persons who can qualify for FHA insurance: by increasing insurance fees and applicable interest rates, and by eliminating protections for homebuyers. FHA funding assistance to private developers in producing housing in areas of short supply should be provided. Provision of new housing in these areas is often critical for groups with special needs such as the elderly and handicapped.

g. Pension Funds

Serious consideration should be given to revising ERISA standards which limit investments in housing by pension funds, insurance companies and others. Of particular significance is the potential for reducing the cost of mortgages through these additional sources. Pension funds represent an untapped, but urgently needed, source of housing credit.

FEDERAL HOUSING POLICY

Federal policies have allowed over 65 percent of Americans to enjoy homeownership and provided over 4.5 million government assisted rental units and 1.3 million public housing units. Sixteen million homes have been purchased under the FHA program. Abandoning these policies will make it almost impossible for most Americans to afford to move for new employment opportunities or better suited retirement dwellings. Eliminating the potential of homeownership for most of the "baby-boom" population that are forming new households in this decade is unacceptable.

Housing production levels in this country are at their lowest in over 30 years at a time when 1.83 million households are expected to join the housing market each year during the next decade. Reversal of these policies will deprive most Americans of their freedom to buy, move, rent or sell housing except at excessive costs.

Federal housing policy objectives cannot leave the financing and production of housing to state and local agencies without the provision of adequate financial assistance; untested fiscal policies cannot be expected to ensure the availability of mortgage money to preserve or increase the housing supply; private initiatives cannot be relied upon to totally address the housing problems of the poor.

PUBLIC HOUSING

The Commission briefly mentions public housing in its Interim Report and suggests its eventual replacement with "vouchers". Public Housing Authorities (PHA's) have been underfunded and have suffered from escalating operating costs at the same time.

Public housing authorities are a ready experiencing difficulty in meeting expenses because of high energy costs, inflation and reduced government assistance. With the further abandonment of PHA's by the Administration, many low-income renters wi be forced to seek housing elsewhere. The Adminstration's proposals are to sel or demo- sh some developments. In the Detroit area the standard quality housing problem wi be exacerbated. The Pres dent's Budget proposes increasing rents, counting food stamps as income, and reducing the operating subs dies for PHA s. New Detroit be eves that the rationa e offered for these proposals fa to take to cons deration the fact that low- ncome persons re having their purchasing power reduced by inflat on, high food costs and slashing of their public assistance budgets. To further increase rents and reduce operating subsidies at this time is both callous and ill-advised.

The estimated effect of computing food stamps as rent will be a 31% increase in rents within two years Further rent increases of 20% were authorized st year raising tenant contr but ons from 25% of ncome to 30%. This procedure too would require the argest fami ies to devote higher proportions of their incomes to rent. At the same time as ren increases are proposed tenant rights are to be eroded by changes in lease and grievances procedures. Energy costs will also be imposed directly on tenants in public housing increasing the amounts they must devote to housing costs at the expense of other necessities Coordinated with these rent increases are plans to reduce funds allocated to operate, maintain and repair existing public housing units. Rent increases of 60% would be required to offset these cuts according to HUD calculations.

THE ELDERLY AND HANDICAPPED

Production of housing for the elderly and handicapped is cut almost in half in the Pres dent's Budget. The Budget proposes to fund only 10,000 units in fiscal year 1983; however on y 40% of the elderly in need of assistance have been accomodated. New Detroit be ieves that the elderly and handicapped require special consideration in the type and tructure of their housing. Special elevators, access ramps, batnroom fac lities and other considerations go into insuring that the housing meets the needs of the elderly and handicapped.

FOOTNOTES

[1]Based upon the 1970 census, the fraction of "dilapidated" housing had decreased to less than 10% and declined to less than 3 percent or 2.25 million units (according to figures cited in the Commission's Interim Report). Among the poorest fifth of the population, 61 percent lived in housing without complete plumbing in 1950, compared to 7 percent (5.25 million) in 1978.

[2]This plan was prepared by the Detroit Planning Department based upon a 3% sampling of residential structures to estimate the number of substandard units. Substandard is defined as lacking in all or some plumbing facilities and the existence of overcrowding (more than 1 person/room).

[3]Based upon Detroit Buildings and Safety Department annual reports, 11,923 units of multi-family housing were demolished between 1975-80 and 4,002 units of multi-family housing units were constructed during that same period. A net loss of 8,000 rental units resulted from these actions during 1975-80.

[4]Based upon tentative eligibility criteria, limiting eligibility to households with incomes under 50% of the area median for a family of four and paying rent in excess of 50% of income, 9% of 17,000 (1,530) renter households would be eligible in Detroit compared with 16% nationally. Comparatively, there have been about 5,000 Section 8 units designated in Detroit since 1975, with 600 to 800 new ones added each year.

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036/202-857-9500

March 16, 1982

Representative Henry B. Gonzalez
Chairman, Subcommittee on Housing
and Community Development
2252 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

On behalf of the National Rural Electric Cooperative Association, I bring to your attention the enclosed resolution adopted by the membership of NRECA at its Annual Meeting on February 10, 1982 in Atlanta, Georgia. The resolution deplores the massive cuts in Farmers Home Administration's rural housing programs for 1983 and urges the funding level of at least that of fiscal 1982. In our opinion, the recommendation that your subcommittee is making in Title IV of H.R. 5731 would certainly be in accordance with our membership's resolution.

The NRECA membership has long supported rural housing programs, particularly those of FmHA. This, of course, is understandable since the rural electric systems serve a very large proportion of the rural population, and these programs have benefited thousands of people who are residents of rural electric cooperative services areas.

We sincerely hope that your subcommittee, and the full Committee, will approve the funding levels for FmHA contained in H.R. 5731.

Sincerely,

William E. Murray

William E. Murray
Legislative Specialist for
Rural Development

WEM:nb

Enclosure

RESOLUTION
ADOPTED BY THE MEMBERSHIP
NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
ANNUAL MEETING - FEBRUARY 10, 1982 - ATLANTA, GEORGIA

Rural Housing

In the mid-1960's, Farmers Home Administration became a major source of financing for rural housing and since then has assisted hundreds of thousands of rural families to acquire decent housing.

Notwithstanding the impressive accomplishments FmHA has achieved and the benefits rendered to so many rural Americans, many of whom are members of rural electric cooperatives, rural areas still contain a disproportionate share of the nation's substandard housing -- about 1.9-million units.

The severe cuts which the Office of Management and Budget have proposed - a reduction from $3.7-billion this year to $1.1-billion next year -- would permit FmHA to provide little more than a token housing program leaving a vacuum that could not be filled by the few mortgage-lending institutions that serve rural areas. Moreover, these cuts, if implemented, would virtually halt construction of rental units for low-income families including the elderly.

We have long supported FmHA's housing program and deplore OMB's efforts to decimate it. We urge the Administration and Congress to fund this important program at least at the current year's level.

FIRST TEXAS
Savings Association

April 14, 1982

Honorable Henry B. Gonzalez
Chairman of
Subcommittee on Housing and Community Development
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

We are pleased to have this opportunity to express views on Section 512 and 513 of HR 5731 for the Hearing record. We appreciate very much your deep concern for the state of the nation's housing that you and the other members of the subcommittee have demonstrated. We share this concern.

Section 512 (b)
Limitations on Participation Agreements

The relationship of the current statutory mortgage limits to the purchase of partricipation interest has been unclear. We understand that this amendment is intended to clarify Congressional intent on this matter. In discussions with your subcommittee staff to obtain their interpretation of existing statutes, their position was that the maximum mortgage purchase limits under existing law are limits on the total principal balance of the loan, not merely on the amount of the participation interest to be purchased. In November, Federal National Mortgage Association (FNMA) announced that the maximum limits applied to the participation interest rather than to the amount of the original loan. An interpretation that mortgage participation purchases would be limited to the total principal obligation of the mortgage without regard to the participation or interest purchased, would eliminate the purchase by FNMA of "nonconforming" loans where FNMA purchases up to $107,000 of the principal balance.

The FNMA policy enables lenders to gain additional liquidity because it makes virtually every loan in a lender's portfolio eligible for at least partial purchase by FNMA. Additional liquidity is especially important in high cost areas where a large share of the loans being originated exceed the statutory limitations in the corporation's Charter Acts. Liberalized limits on participations would permit the Federal Home Loan Mortgage Corporation (FHLMC) and FNMA to provide lenders with needed liquidity without ignoring the low and middle income households the subcommittee wants to insure will be served. A great majority of their participation purchases are 85% - 95% of the total principal balance of the loan. The number of very high priced houses for which participations are purchased should always be low because lenders do not want to keep large illiquid residuals in their portfolio. In any event, I have been assured by both corporations that they have no intention of abendoning their traditional role in providing funds for low and middle income families.

Section 513 (b)
Purchase of Second Mortgages

Expanding the Mortgage Corporation's loan purchase authority to include second mortgage intended to finance the purchase of a home is an important change in view of the National Association of Realtors estimates that one third of the houses purchased in the United States last year involved secondary financing. We strongly support this expansion of authority.

For the past two years the corporations have established their own loan limits for second mortgages purchased under their pilot Home Improvement Loan Programs. They have not abused this authority to adjust their limits to reflect market development and we feel that such flexibility is essential to the operation of a responsive secondary marke Congress intended in its 1978 authorization of the HIL Program (Sec. 1702 of PUBLIC LAW 95-630) that its loan limits be linked to the limits imposed on federal savings and loan associations by the Federal Home Loan Bank Board.

However, following Congressional intent in the financial institution's Deregulation Monetary Control Act of 1980, the FHLBB has removed all dollar limitations, instead relating lending limits to maximum loan-to-value ratios. In the case of the Mortgage Corporation current HIL limits of $15,000, $40,000, and $60,000, they reflect policy rather than the Federal Home Loan Bank Board regulations. Since the real test of soundness, which should govern the extent of participation, is the total financing-to-value ratio, the Mortgage Corporation is now reviewing the possibility of increasing the HIL limits.

A widespread concern among lenders, which we share that restricting the Mortgage Corporation in the areas of total financing-to-value and loan amount would put an additional burden on an industry which is already strapped for loanable funds. Statutory limits quickly become out of date and would impede the Mortgage Corporation s ability to bring funds from capital surplus to capital deficit areas In addition, the restrictions in Section 513 would force some borrowers away from traditional lenders which sell to FNMA and to the Mortgage Corporation.

The statutory restrictions on the use of home improvement loan proceeds only for home improvements has already prevented the Mortgage Corporation from responding to marke demands and providing lenders with needed liquidity Borrowers of home improvement loans almost always intend to finance both eligible improvements and some personal needs such as education or vacation with the proceeds. As a result the HIL Program has never had significant usage by lenders who cite the statutory restrictions on the use of the loan proceeds as the chief impediment. Further restrictions on this program may result in so little use as to make this pilot program economically unfeasible.

Not only is the language imposing loan limits for second liens inconsistent with current authority to establish loan limits on HIL it is very restrictive in view of the authority extended for purchase money seconds. Limiting these second liens, which are usually higher loan amounts than the restricted use HIL's, would further inhibit financing residential sales today.

In addition to the dollar limits, a maximum loan-to-value ratio of 80% of the "appraised value" of the dwelling has been proposed. This is more restrictive than current regulatory authority and industry practice. While we agree that a ratio of total financing-to-value is appropriate for prudent lending, we feel that it should not be set by statute.

For example, the current Charter Act does not have a maximum loan-to-value ratio for first lien loans. Rather it requires mortgage insurance for loans with a ratio higher than 80%. In our view, the applicable total financing-to-value requirement for second mortgages should be the same as the ratio for our first lien mortgages.

We also urge that the term "appraisal" be deleted from the bill. This term is not used in the loan-to-value provision of the Charter Act governing first mortgages (Section 305 (a) (2)). Moreover appraisals can be expensive for the borrower and are often unnecessary for smaller loans. The Mortgage Corporation has developed and is using effective streamlined techniques for estimating value in its HIL Program, thereby avoiding the expense of a full appraisal. We hope you will leave the method of estimating value to our discretion in that it means savings to customers.

Similarly, we oppose a statutory requirement that restricts second mortgages to residences which are owner occupied. As circumstances have made it increasingly difficult both for renter households to afford ownership and for owners to sell residences upon transfer. We do not want to preclude access to financing which increases the supply of standard rental housing. Although the Mortgage Corporation does not purchase mortgages on such non-owner occupied rental property, we would like to see them retain the flexibility to respond to market developments and the potential for an acute need for liquidity.

Finally, we would like to offer some technical comments on the language proposed in Sections 512 and 513. They are as follows:

1. PARTIAL FINANCING: Section 513 (a) of the bill would make an amendment to the Federal National Mortgage Association's Act (the FNMA Charter Act) to give FNMA the authority to purchase second mortgages on a residence - the improvement of which was financed <u>in whole or in part</u> by such mortgage. The Mortgage Corporation's Charter Act does not contain the "in whole or in part" language. Rather the Charter Act permits the purchase only of a loan "the proceeds of which are intended to finance the rehabilitation" etc. of property (Section 302 (h).

In essence, we believe that the language setting forth the FNMA and Mortgage Corporation authority in this regard should be the same. In order to maintain parity, Section 302 (h) of the Charter Act should be amended by inserting "in whole or in part" after "finance".

2. "Seconds" versus MORE SUBORDINATE LIENS: Section 513 (b) (1) of the bill refers to financing in a "secondary" manner the purchase of a home. This provision could be read to preclude the purchase of third or fourth mortgages which are becoming frequent vehicles for home finance. If this provision is intended to limit the Mortgage Corporation to purchase of seconds only, we would suggest that risk management is adequately addressed by the maximum total financing-to-value ratio rather than whether the junior lien is a second position, third, or otherwise. If the limitation is not intended, we suggest that "junior" or "subordinate" might be a more appropriate term.

3. INCONSISTENT LIMITS: Section 513 (b) (2) of the bill would impose a \$60,000 limit on a <u>two to four family</u> residence for the Mortgage Corporation. By contrast, Section 513 (a) would impose a \$60,000 on a <u>two family</u> residence for FNMA. We are opposed to any limits, but any limits which should be imposed should be consistent to both FNMA and the Mortgage Corporation.

In conclusion, Mr. Chairman, we look forward to working with you to further serve the housing needs of the nation's citizens.

Sincerely,

Jack R. Taylor

Jack R. Taylor
Vice President

International Artists

Wholesale Paintings - Frames

Rep Henry R Gonzalez
Chairman, Housing and Community Development
Rayburn House Office Building
Washington, D. C. 20515

Dear Representative Gonzalez,

Both the Senate and the House is studying new suggestions for housing assistance programs.

I am submitting recommendations for changes in the subsidized home purchase programs and the subsidized "section 8" rental assistance programs.

If properly instituted, these changes could save the American tax-payers Billions of dollars in a couple of decades.

Sincerely,

Floyd E Rolfe

566 North 50th Way • Phoenix, Arizona 85008 • (602) 267-9124

HOUSING PROGRAM RECOMMENDATIONS- FLOYD E ROLFE

1. There is in existance, Authorization for Temporary Mortgage Assistance Payments and growing pressure to apply this program. I would recommend aga nst it unless the government can take some type of equity position in this type of loan or subs dy to protect the government's financial committment to the loan Another requirement should make the home owner go through debt counsel ng and a debt repayment program. There are some homeowners who have mortgage payment prob ems because of legitimate "out-of-work situations but many of these people simply live at too high of a "material" level in all thei consumer spending.

2. All subsidized housing purchase programs should be revised to a type of "SAM" (Shared Appreciation Mortgage) program, whereby the government shares an equity position in the property. For example, if interest rates are 5% and we are subsidizing a lower income housing mortgage at 12%, the government should take a /4 shared appreciation equity position in the mortgage Or, if under other programs, mortgage payment is $500 and government is subsidi ing $125 monthly, then we should also take a 1/4 "shared appreciation" equity in that loan subsidy. Under this method, government would eventually recover al the subsidy that it put into subsidized mortgages and the homeowner or heirs would not profit at the taxpayers expense.

3. The "Section 8" Subsidized leasing program should be terminated. This is a frightful waste of government money. Th s rogram provides a rental directly to the landlord that is partly subsidized by the government for lower income people. For example, a couple earning or retired at $14,000 per year can have their unit subsidized at $291 for a $450 apartment or $200 for a $396 apartment.

Under this system the government will be continually and forever paying out subsidies for low income housing and only the landlord benefits The taxpayer takes a screwing. This program should be terminated and the same amount of subsidy should be given to local government to pay for "scattered site" public housing f we would build scattered site public housing with this same amount of government subsidy going to loca government we would have hundreds of thousands of un ts of public housing paid for within 25 years. Under "section 8" we will pay out forever and forever.

Local units of government could float bond issues to build "scattered site" housing, the lower interest rate would allow for more units to be built. Private industry would build the housing. The tenant would reimburse local government for his share of the rent and the federal government would reimburse the local government for the subsidized portion.

We would not only produce housing at a lower cost but we would also be paying for units of "scattered site" public housing and not forever paying out a subsidy. These proposed revisions in our subsidized purchase and rental programs will save the taxpayers billions of dollars over a couple of decades.

If you need further technical assistance please write me.

Floyd E Rolfe
Rolfe Business Investors
Licensed Real Estate Broker
566 North 50th Way
Phoenix, Arizona 85008

Testimony

Committee Chairman and Members of the House Select Committee: My name is Robert B. Peacock, I am the Executive Administrative Director for the Fond du Lac Reservation, Minnesota Chippewa Tribe, Minnesota. I wish to thank you for allowing me the time to express the concerns of the Fond du Lac Reservation in reference to the President's recission of 4,000 homes for FY 82 in the Indian Housing Program. I request on behalf of the Fond du Lac Reservation that our comments be made a part of the official record of this hearing.

The Fond du Lac Reservation currently has under construction 50 low-rent and mutual help housing units. We received the program reservation for these homes in April, 1980, and at present are expecting to receive final word in order to start construction of 50 additional homes delegated to us in April, 1981. These two projects when completed will only meet 1/3 of our current housing needs. Our experience in finalizing both of the projects has exposed these problem areas:

1. Interdepartmental agreement between IHS, HUD and BIA. The Interdepartmental agreement has proven itself too cumbersome because of the lack of cooperation among the agencies. For example, IHS has been unable to meet developmental deadlines, housing site approvals and ongoing inspections because of being understaffed and unable to receive adequate travel expenses. The BIA, MN. Agency backlog on road construction for housing in our area is behind schedule by ten years. This coupled with the delay in lease finalization for housing sites delays the project and further backlogs housing in the pipeline.

Paperwork! The avalanche of rules, regulations, special agency forms and changes of same, from HUD, often means that work completed must be done over in order to comply with new rules, regulations, special agency forms and future changes, which in turn, etc...etc...

2. The checkerboard pattern of land ownership on the Fond du Lac Reservation and the HUD policy that all homes must be constructed on trust lands creates unnecessary delays. The confusing webs of jurisdiction ownership and tenure of land on the Fond du Lac Reservation is the direct result of the many extreme changes in federal policy toward Indians during the last century. Additionally, HUD does not provide for site purchase expenses in Indian Housing as it does in the other public housing programs. Now, a new HUD policy has surfaced. This policy states that no future Indian homes may be built on land that is in the process of being put into trust. On Fond du Lac, we have purchased over 500 acres of former Indian land which was to complement our Tribal land for use as future home sites. This new policy prevents us from utilizing the land until placing in trust status has been completed. (see Attachment A). This problem of land ownership and jurisdiction is unique to all Indian Housing Programs.

At this point, I would like to expound on the positive results of continuing the Indian Housing Programs other than the obvious benefit of some of the people having their basic need for decent, safe and sanitary housing met. One of the common problems cited in Indian Housing Programs is the high cost of construction. Prior to Fond du Lac receiving their housing projects, we had only 2 Journeymen and no apprentices in the construction trades.

Currently, we have established a Dept. of Labor recognized apprenticeship program which has enrolled over 20 individuals in the construction trades. This program has enabled us to provide jobs and training which will result in Journeymen status for our people which would not have occurred except for the Indian Housing Programs. The apprenticeship program also allows us under the rules and regulations of the Bacon-Davis Act to reduce labor costs, and provides a local, trained, labor force that enables the Fond du Lac Reservation to avoid the high cost of importing construction labor.

The development and administration of the housing projects presently underway on the Fond du Lac Reservation has enabled us to test and develop our administrative capabilities. The Fond du Lac Reservation's goal of self-determination requires the administrative ability to handle complex projects. This ability can only be learned and tested through hands-on experience. The Indian housing programs provide this experience and will pay dividends in the future years in the provision of Reservation people with the necessary administrative capabilities to tackle the reservation's complex problems.

To date, Indians who make up less than 1% of the population have experienced more than 3% of the cuts in the Federal Budgets. In hard facts, this means that to enrolled members of the Fond du Lac Reservation:

Because of economic hardships -

- 21% more people are now forced to accept fuel assistance.
- 150 women and children have been cut off the WIC program.
- more than 35% of the people employed by the Reservation have been terminated because of Federal budget cuts.

Now this administration proposes to establish the zero policy in programs providing basic needs to Indians, including:

HUD Section 202 elderly housing: -0- and rescind FY 82 funds and liquidate assets.

HUD Assisted Housing (New Construction): -0- for FY 83 and rescind FY 82 funds.

HUD CDBG: To be -0- in FY 84.

HUD UDAG: To be -0- in FY 84.

BIA new road construction: -0-

IHS Sanitation Facilities for new and existing homes: -0-

The people of the Fond du Lac Reservation believe that the purpose of having a Democratic Society is to assist the people in meeting their basic needs. The proposed budget and recissions will deny the people these basic needs.

The Fond du Lac Reservation, Minnesota Chippewa Tribe requests that you oppose the President's Recissions and support continued and additional funding for programs aiding Indian People.

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